DEBT CAPITALISATION: INVESTIGATING THE TERM 'REDUCTION AMOUNT' IN THE INCOME TAX ACT 58 OF 1962

by

Pieter Johan Janse van Rensburg

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Supervisor: Mr Rudie Nel

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DECLARATION

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SUMMARY

The capitalisation of debt in exchange for the issuance of shares is a common occurrence, not only in South Africa, but also internationally. Generally, there are three methods through which debts are capitalised, being the direct issue of shares (with or without cash flow), capitalisation through set-off and the conversion of debt instruments into shares. Since the introduction of section 19 of the Income Tax Act 58 of 1962 (‘the Act’) and paragraph 12A to the Eighth Schedule of the Act on 1 January 2013, there has been uncertainty whether any of the methods of debt capitalisation would result in a ‘reduction amount’ in terms of which the debt reduction regime applies. The number of taxpayers that have approached the South African Revenue Service (‘SARS’) to issue Binding Private Rulings (‘BPRs’) on the various methods of debt capitalisation highlights the uncertainty.

The study addresses these uncertainties through a critical analysis of the terms ‘amount applied’ and ‘consideration’. Each of the methods of capitalisation are separately evaluated in terms of these definitions, as well as considering issues that are specifically related to the respective methods of capitalisation. Furthermore, the study analyses BPRs on debt capitalisation that have been issued by the SARS to determine if current practices of debt capitalisation support the analysis in terms of income tax legislation. Uncertainties from recent proposed tax legislative amendments dealing with debt capitalisation are also discussed.

The conclusion is reached that all of the methods of capitalisation considered constitute an ‘amount applied’ as ‘consideration’ towards the reduction of debt as contemplated in section 19 of the Act and paragraph 12A to the Eighth Schedule of the Act. To the extent that the market value of shares issued equals the face value of the capitalised debt, no ‘reduction amount’ arises. The study shows that this conclusion can be aligned with the limited precedent in case law on debt capitalisation. A significant finding is that for set-off as a method of debt capitalisation, value mismatches between subscription loans and the market value of shares issued could attract adverse tax consequences in terms of section 24BA if shares have been issued at a discount or a premium to the value of the subscription loan. Based on the research findings it is suggested that if the factual circumstances do not provide for an exclusion from the application of section 24BA, set-off could be regarded as a less favourable method of debt capitalisation.

OPSOMMING

Die kapitalisering van skuld in ruil vir die uitreiking van aandele is ŉ algemene verskynsel, nie net in Suid-Afrika nie, maar ook internasionaal. Oor die algemeen is daar drie wyses waarop skuld gekapitaliseer kan word, naamlik deur die direkte uitreik van aandele (met of sonder kontantvloei), deur skuldvergelyking en die omsetting van skuldinstrumente in aandele. Sedert die inwerkingtreding van artikel 19 van die Inkomstebelastingwet 58 van 1962 (‘die Wet’) en paragraaf 12A van die Agste Bylaag van die Wet op 1 Januarie 2013, heers daar onsekerheid of enige van die metodes van skuldkapitalisering aanleiding gee tot ŉ ‘verminderingsbedrag’ ten opsigte waarvan die skuldverminderingsreëls van toepassing is. Die aantal belastingpligtiges wat die Suid-Afrikaanse Inkomstediens (‘SAID’) onlangs genader het om Privaat Bindende Beslissings (‘PBBs’) uit te reik oor die verskillende metodes van skuldkapitalisering beklemtoon die onsekerhede.

Die studie spreek die onsekerhede aan deur ŉ kritiese ontleding van die terme ‘bedrag aangewend’ en ‘vergoeding’. Elk van die metodes van kapitalisering word individueel ontleed in terme van hierdie definisies, sowel as die oorweging van aspekte wat spesifiek van toepassing is op die onderskeie metodes van kapitalisering. Die studie ontleed verder die PBBs wat deur die SAID uitgereik is wat handel oor skuldkapitalisering, om vas te stel of huidige praktyke van skuldkapitalisering die ontleding daarvan in terme van inkomstebelastingwetgewing ondersteun. Onsekerhede wat voortspruit uit onlangse voorgestelde belastingwetwysigings word ook bespreek.

Daar word bevind dat al die metodes van skuldkapitalisering wat oorweeg is ŉ ‘bedrag aangewend’ as ‘vergoeding’ behels vir doeleindes van skuldvermindering soos beoog in artikel 19 van die Wet en paragraaf 12A van die Agste Bylaag van die Wet. Na die mate wat die markwaarde van aandele uitgereik gelyk is aan die sigwaarde van die gekapitaliseerde skuld, ontstaan daar geen ‘verminderingsbedrag’ nie. Die studie bevind dat hierdie gevolgtrekking versoenbaar is met die beperkte regspraak oor skuldkapitalisering. ŉ Betekenisvolle bevinding is dat met skuldvergelyking as metode van skuldkapitalisering, verskille tussen die waardes van lenings wat voortspruit uit die inskryf op aandele en die markwaarde van aandele wat uitgereik word nadelige belastinggevolge mag inhou in terme van artikel 24BA, indien aandele teen ŉ diskonto of premie uitgereik is. Op grond van die resultate van die navorsing, word daar aan die hand gedoen dat indien die omstandighede nie voorsiening maak vir verligting van die toepassing van artikel 24BA nie, kan skuldvergelyking as ŉ minder gunstige metode van skuldkapitalisering beskou word.

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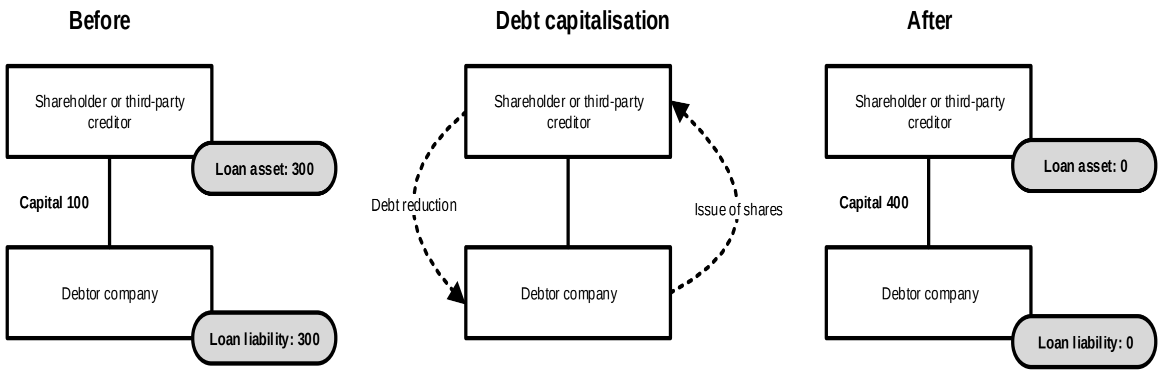
CHAPTER 1
INTRODUCTION

1.1 Background to debt capitalisation

Companies finance their assets and operations through a combination of debt and equity (Van der Linde, 2011:2). The combination or ratio in which debt and equity, respectively, are used to finance assets and operations (the so-called capital structure or debt-equity ratio) depends on a variety of factors, including macro-economic factors and the cost of obtaining different types of finance (Van der Linde, 2011:2). In making the decision to fund assets and operations through either debt or equity, tax is one of the main influencing factors (Van der Linde, 2011:8). This is substantiated by the fact that the Income Tax Act 58 of 1962, as amended ('the Act') also acknowledges that debt can be akin to equity as a means of funding and contains re-characterisation rules for debt (and interest) and equity (and dividends) in sections 8E, 8EA, 8F and 8FA. Given the potential tax consequences of the funding decision, it is vital for companies to be able to adapt the ratio of debt and equity funding in line with changing circumstances. A method through which this can be achieved, is debt capitalisation (Chadbourne and Parke LLP, 2002:3)

Debt capitalisation is an arrangement where a holder of shares converts debt to equity (KPMG New Zealand, 2015:1). Stated differently, debt capitalisation is the process whereby the consideration for shares issued by a company takes the form of the discharge of an existing debt (SARS, 2016c:10). It is possible that not only shareholder debt, but also third-party debts can be capitalised in exchange for shares, a technique that has been considered by South African corporates, as was the case in *CIR v Datakor Engineering (Pty) Ltd (1998) 4 All SA 414 (A)*. Furthermore, debt that can be capitalised is not limited to private debt but can also include public debt. This is evident from the 2014 Medium Term Budget Policy Statement Speech, where the then Minister of Finance, Nhlanhla Nene, indicated that, if necessary, consideration will be given to partially capitalise Government's R60-billion loan to parastatal Eskom (National Treasury, 2014:8). When debt capitalisation occurs, the *quid pro quo* received by the creditor company in exchange for the reduction of the debt is shares in the debtor company (SARS, 2015d:139). Debt capitalisation is not only concluded at the instance of debtor and creditor companies, but can be required through regulation as well. Many real estate investment trusts ('REITs') have recently undergone a capital restructure due to the listing requirements of the Johannesburg Stock Exchange (Johannesburg Stock Exchange, 2017a:428). Part of this capital restructure was cancelling the debenture part of their linked-unit capital and capitalising the issue price of the debenture to stated capital, as envisaged in section 25BB(8). Debt capitalisation can be illustrated as follows:

Figure 1.1: Graphical illustration of debt capitalisation



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Debt capitalisation could be achieved either directly or indirectly (SARS, 2015d:140) and the method through which taxpayers capitalise their debts is an important consideration. Van der Zwan (2014:2) indicates, with reference to the judgement in *C:SARS v Labat Africa Ltd* 74 SATC 1 (SCA), that a single transaction could have different tax outcomes than a series of transactions that give exactly the same outcome as the single transaction does. This is important in the context of debt capitalisations, as the effective outcome can be achieved by means of the following three methods (SARS, 2015d:140):

- Direct settlement: issuing shares directly in settlement of the debt;
- Set-off: issuing shares and setting off the subscription loan owed by the subscriber against an amount owed by the company; and
- Conversion: converting debt into shares in fulfilment of the conversion rights attaching to the debt, such as convertible debentures.

1.2 Recent tax focus on debt capitalisation

When debts are capitalised, there is a concern that the debt capitalisation transaction could result in the application of the debt reduction provisions of the Act which are contained in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. Some debate currently exists if debt capitalisation may result in the reduction of debt (Van der Zwan, 2014:1).

Prior to the effective date of section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act on 1 January 2013, only Binding Private Ruling ('BPR') 124 (22 October 2012) dealt with the tax consequences of debt capitalisation. Since then, BPR 173 (2 July 2014), BPR 193 (15 June 2015), BPR 208 (8 October 2015), BPR 213 (17 December 2015), and BPR 246 (24 August 2016) have all expressly dealt with the tax consequences of debt capitalisation. From this increase in the number of BPRs issued by the South African Revenue Service ('SARS') dealing with debt capitalisation since the introduction of section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act, it is clear that recently there has been an increased focus on the tax consequences thereof by taxpayers. According to Louw (2015:1), the increased focus stem from the principles laid down in *C:SARS v Labat Africa Ltd*, where it was held that the issue of shares does not diminish a company's assets and therefore does not constitute expenditure incurred.

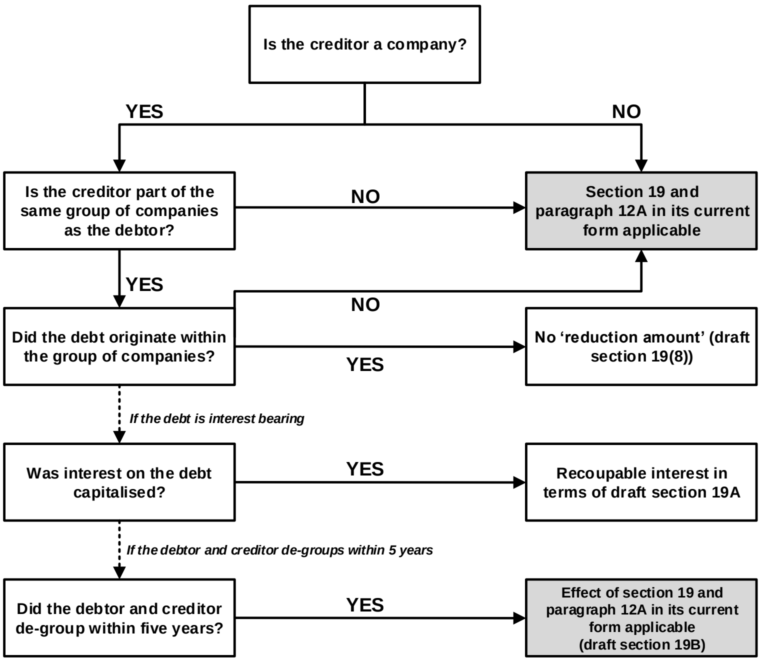
Courts have not previously considered the key terms – 'reduction amount' and 'consideration' – contained in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. Neither has its similarities (and contrasts) to the term 'expenditure', as envisaged in the *C:SARS v Labat Africa Ltd* judgement, been considered before in court. The SARS has also not provided clear guidance on whether the issue of shares in the reduction of debt in its various forms may result in the application of the debt reduction provisions. Sadiki (2016:1), in commenting on BPR 246 dealing with debt capitalisation, summarises the current position: "SARS's recently issued interpretation note on debt reduction seems to keep the water muddied."

On 19 July 2017, National Treasury issued the 2017 Draft Taxation Laws Amendment Bill (the 'Draft debt reduction provisions'), which specifically proposes (National Treasury, 2017b):

- Section 19(8)(*e*): allowing for certain intra-group debt ('qualifying debt') to be capitalised without resulting in a 'reduction amount';
- Section 19A: recoupment of deductions in respect of interest incurred on intra-group debt that has been capitalised; and
- Section 19B: recoupment of amounts on intra-group debt that have been capitalised when the debtor and creditor de-group within five years after debt capitalisation.

The Draft debt reduction provisions are based on debt that was reduced or settled 'directly' or 'indirectly' in terms of section 19(8)(*e*) and section 19B. However, the proposals do not define the methods regarded as 'indirectly' reducing or settling a debt and whether or not set-off and conversion would be regarded as 'indirectly'. Furthermore, the Draft debt reduction provisions retain the concept of a 'reduction amount' although proposed that the definition thereof be moved to section 1 of the Act. The application of the Draft debt reduction provisions, if legislated in its current form, will have the following interaction with the current debt reduction regime:

Figure 1.2 Interaction between current debt reduction regime and draft proposals



Author compiled

From **Figure 1.2** it is clear that section 19 and paragraph 12A will still be applicable to debt capitalisation, given the very specific characteristics of the qualifying debt and the debtor-creditor relationship required for relief in terms of the Draft debt reduction provisions. In the Draft Explanatory Memorandum dealing with the proposed amendments, National Treasury (2017c:23) refers to the BPRs that have been issued by the SARS, indicating that the rulings provide "***relief*** in respect of the application of the ***current tax rules***" (own emphasis). The fact that the Legislature acknowledges that the BPRs provide relief from the current debt reduction regime, is an indication that the Legislature considers that debt capitalisation in its current form constitutes a 'reduction amount'. However, the Draft debt reduction provisions do not address the tax consequences of debt capitalisation in its entirety. There is lacking guidance on debt capitalisations that fall outside of the scope of the draft legislative amendments, specifically relating to the three different methods of debt capitalisation. Matters specific to each method of capitalisation, as well as possible circumstances in which a 'reduction amount' could result for each method, are not addressed. Van der Zwan (2015:3) highlights the fact that there are provisions of the Act, other than the debt reduction regime, that may also be applicable to debt capitalisation, such as section 24BA. The interaction of other provisions of the Act is also not addressed in the Draft debt reduction provisions or explanatory information thereto.

1.3 Research question

Despite the practical and widespread use of debt capitalisation, there is currently a lack of clear guidance on whether debt capitalisation would result in the application of the debt reduction provisions contained in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. The BPRs issued by the SARS do not advance reasons for the rulings issued and no case law provides guidance on debt capitalisation under section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. Although the Draft debt reduction provisions, if legislated in the current form, will regulate intra-group debt capitalisation to a limited degree, the provisions are only applicable to qualifying debt within a group of companies.

The uncertainty of whether debt capitalisation constitutes an amount 'applied as consideration' remains in respect of debt that does not meet the criteria as set out in the Draft debt reduction provisions, third-party debts as well as debts that were capitalised prior to the proposed amendments becoming effective.

The primary research problem identified is whether debt capitalisation (the issue of shares in reduction of debt) constitutes a 'reduction amount' contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. Given that there are three methods of debt capitalisation, the primary research problem will be addressed by investigating the following research questions:

(i) Would issuing shares, in direct settlement, constitute an 'amount applied as consideration' as contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act and thus not result in a 'reduction amount'?

(ii) Would set-off result in a 'reduction amount' contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act?

(iii) Would the conversion of debt into shares, in fulfilment of the conversion rights attached to the debt, amount to a 'reduction amount' contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act?

A secondary research problem stems from other areas of tax uncertainty identified in addressing the primary research questions. The identification and discussion of areas of tax uncertainty is relevant to debt capitalisation and particularly if it could result in adverse tax consequences or administrative responsibilities imposed on the debtor and creditor.

1.4 Literature review

The literature review briefly addresses the research questions identified as part of the problem statement. Apart from reference to sources already mentioned in the background information, additional sources that will provide guidance on concluding the research questions are referred to.

1.4.1 Direct settlement

The concern that debt capitalisation could trigger the debt reduction provisions of the Act centres around the definition of a 'reduction amount', which means the amount by which a debt is reduced less any amount applied as 'consideration for that reduction' as contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. Van der Zwan (2014:2) indicates that the *C:SARS v Labat Africa Ltd* judgement concerned itself with the term 'expenditure' and not 'consideration' as part of the definition of 'reduction amount'. Van der Zwan (2014:2) submits that debt capitalisation should not result in a reduction for purposes of the debt reduction provisions if the value of the shares issued as consideration is equal to the amount of the debt reduced. This argument suggests that the issuing shares should amount to 'consideration' for the reduction of the debts based on the following extract from the *C:SARS v Labat Africa Ltd* judgement, with reference to *Osborne v Steel Barrel Co Ltd* (1942) 1 All ER 634 (CA):

> *The court decided that the issue of shares for the acquisition of assets amounted to 'consideration' given by the company. That is hardly contentious.*

However, in *CIR v Datakor Engineering*, it was held that:

> *The mere substitution of a creditor's claim with a share, even a redeemable preference share, amounts to concession. An enforceable obligation is replaced with something of a completely different nature.*

Visser (2014:1) suggests that, even though the *CIR v Datakor Engineering* judgement was prior to the introduction of section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act, it may still be relevant. Van Reenen (2015:14) indicates that Visser's view is in line with that expressed by the SARS, but only to the extent that the market value of the shares issued as part of the debt capitalisation is less than the face value of the debt. When considering the respective judgements, on the one hand it is accepted that the issue of shares amounts to 'consideration', and on the other that it amounts to a 'concession'. The potential different conclusions that can be reached when considering the judgements, creates uncertainty on whether issuing shares in direct settlement for debt constitutes an amount 'applied as consideration' as contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act.

The SARS recognises that issuing shares in direct settlement of a debt can be done through utilising cash flow (SARS, 2016c:11), and certain rulings have been made subject to this requirement (BPR 124). Direct settlement of debt through the issuance of shares requires consideration, not only with reference to the two Supreme Court of Appeal judgements, but also with reference to the implications involving cash flow.

1.4.2 Set-off

The SARS (2015d:140) recognises that set-off can comprise a valid form of payment that discharges a debt. However, the nature of set-off remains unclear (Van Deventer, 2016:2), despite the general use and acceptance thereof. De Kock (2012:54), with reference to De Wet and Van Wyk (1992:272), also suggests that set-off is one of the most complex areas in the South African law of contract.

From a legal perspective, Jafta J determined in *Siltek Holdings (Pty) Ltd (in liquidation) t/a Workgroup v Business Connexion Solutions (Pty)* Ltd (2009) 1 All SA 571 (SCA) that set-off takes place if two parties owe each other liquidated debts, which are payable, and that in essence set-off constitutes a form of payment by one party to the other. The judge emphasised that for set-off to come into operation, both debts need to be payable. Not only are there certain legal requirements that should be met, but the International Financial Reporting Standards (International Accounting Standards Board, 2015:1250) also prescribe characteristics that transactions should have before set-off can be applied, specifically that the parties concerned:

- have a legal and enforceable right to set off the recognised amounts; and
- intend to either settle on a net basis or to realise the asset and settle the liability simultaneously.

In BPR 193 and BPR 255, the only rulings that deal with debt capitalisation through set-off, the SARS does not provide a reason for why section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act do not apply or why set-off is considered to be an amount applied in reduction of the debt. Since either party does not require performance (Van Deventer, 2016:1) and the required result can be obtained through book entries, many practical difficulties and costs are removed in the process when set-off is applied. Therefore, if it can be demonstrated that set-off can indeed be validly applied for debt capitalisation if certain requirements are met, this could be a cost-effective method of capital restructuring. Given the complex nature of set-off and the limited guidance thereon in the context of debt capitalisation, it remains uncertain whether set-off would result in a 'reduction amount' as contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act.

1.4.3 Conversion

Unlike debt that can be converted into shares through direct settlement and set-off, a 'linked unit' consists of a debt and equity component from the outset, comprising a debenture and a share that are traded together as a single unit. A feature of the linked units is that the debt portion can be converted into equity, by cancelling the debenture and capitalising the debt to equity, as envisaged in section 25BB(8), effectively providing the same result as would be achieved through direct settlement and set-off. This concept is particularly prevalent in the REIT regime. Historically, there have been two forms of listed property investment entities in South Africa, namely Property Loan Stocks Companies ('PLSs') and Property Unit Trusts (PUTs) (SA Reit Association, 2017:3). With the introduction of the REIT regime in South Africa in 2013, a tax dispensation was introduced that created parity between PLSs and PUTs (Financial Services Board, 2014:7). Many PUTs had complex capital structures, where shareholders held linked units consisting of a share and a debenture, with the bulk of the value of the unit being attributable to the debenture, typically in a 99:1 ratio (PricewaterhouseCoopers, 2013:38).

The REIT regime removed the complexity by delinking the debenture and the share and having an equity-only structure. In 2013, the Investec Property Fund Ltd (Investec Property Fund Ltd, 2013:1) underwent the conversion from a linked-unit capital structure into an equity-only capital structure, while in 2014 and 2015 respectively, Hyprop Investments Ltd (Hyprop Investments Ltd, 2014:1) and Orion Real Estate Ltd (Orion Real Estate Ltd, 2015:1) followed suit. Section 25BB(8) provides that if a REIT cancels the debenture that formed part of the linked unit and capitalises the issue price of the debenture to the stated capital of the REIT, the cancellation of the debenture must be disregarded in determining the taxable income of the REIT. Kantilal (2016:40) suggests that the relief provided for in section 25BB(8) when the debenture part of linked units are cancelled, is specifically focused on the potential negative income tax consequences that may occur with debt reduction or debt cancellation.

The fact that the Legislature specifically excludes debt reduction for the REIT regime when debt instruments are converted into capital, could be indicative that the capitalisation of debt instruments could lead to a debt reduction, otherwise there would have been no reason for the specific inclusion.

The SARS (2016c:11) also recognises that shares can be issued in fulfilment of conversion rights that were attached to the debt instrument at the time of issue and that these debt instruments are accordingly a type of a hybrid instrument. The conversion of debt instruments to equity may also have a significant interaction with sections 8F and 8FA of the Act that are specific anti-avoidance re-characterisation provisions. These anti-avoidance provisions on hybrid instruments and the REIT regime's specific relief from the potential negative income tax consequences from debt reduction or debt cancellation create uncertainty for taxpayers. Specifically, it remains uncertain whether the conversion of debt into shares amount to a 'reduction amount' contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act.

1.5 Research objectives and importance of the study

For each of the primary research questions stipulated in section 1.3 the following primary research objectives are proposed:

(i) To critically analyse the terms 'reduction amount' and 'consideration' as well as the finding in *CIR v Datakor Engineering* that debt capitalisation amounts to a 'concession'. This critical analysis will be performed in order to determine whether issuing shares in direct settlement of debt constitutes 'consideration' or whether it would result in a 'reduction amount', in respect of which the debt reduction regime applies. The critical analysis is also required to establish if the findings in *CIR v Datakor Engineering* is still relevant in terms of the current debt reduction regime contained in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act;

(ii) To investigate if debt capitalisation through set-off can result in the application of the debt reduction provisions. This investigation aims to provide guidance on the requirements for set-off in the context of debt capitalisation; and

(iii) To investigate the consequences of the conversion of debt instruments to equity through the conversion rights that are attached to the debt instruments stipulated in security documents. The investigation is conducted to establish if conversion of debt instruments to equity can lead to a 'reduction amount'.

For each of the three methods of debt capitalisation considered, the anti-avoidance implications of section 24BA in the case of a value mismatch is also investigated. Since section 24BA and the debt reduction regime are not mutually exclusive, this investigation is performed to establish if there are any adverse tax implications imposed by section 24BA on the different methods of debt capitalisation, beyond the application of section 19 and paragraph 12A.

A secondary objective of this study stems from other areas of tax uncertainty identified in considering literature relating to the primary research problem. This study also aims to document such uncertainty in order to highlight relevant matters that could fundamentally affect debt capitalisation transactions, resulting in adverse tax consequences or administrative responsibilities imposed on the debtor and creditor. The inclusion of these areas of uncertainty also could also provide a basis for further research into debt capitalisation.

1.6 Limitations of scope

This study will not extend to examine the detail of tax consequences of section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act when addressing the research questions. While an analysis of these sections is beyond the scope of this study, this is indeed a topic for further research. This is especially the case in light of Interpretation Note 91: Reduction of Debt, published by the SARS on 21 October 2016 (SARS, 2016:c), and Sadiki's (2016:1) comments that the Interpretation Note on debt reduction keeps the water muddied. Although reference is made throughout the study to the Draft debt reduction provisions to support research findings, these provisions will not be critically analysed, as the draft is subject to public comment and could be amended before acceptance and eventual promulgation. Furthermore, since interest-bearing debt is an 'instrument' as defined in section 24J(1), the provisions dealing with adjusted gains or losses in terms of section 24J(4) are also relevant to all three methods of debt capitalisation. An investigation into the specific tax consequences of the latter mentioned provisions on debt reduction are, however, beyond the scope of the study and not investigated in detail for each of the three methods.

1.7 Research methodology

The research method adopted to answer the questions identified in the problem statement will be a review of relevant literature, including relevant provisions of the Act, BPRs, case law, as well as authoritative scholars in the field of taxation. As the primary research questions will be answered in the context of South African legislation, the majority of literature considered will be local.

This study involves a non-empirical interpretative analysis of tax legislation and incorporates other literature on the research objective. The mode of inquiry for this study is qualitative in nature and follows a doctrinal method as described by Hutchinson and Duncan (2012:101). In terms of this method the specific requirements of the Act were firstly identified and the issues regarding interpretation from a legislative perspective analysed. This was followed by the identification of sources of which the primary sources were accepted as case law, interpretations and guides from the SARS, articles, dissertations and academic books. The sources were consulted to obtain an understanding of the interpretation of current provisions of the Act in the absence of guidance specifically pertaining to debt capitalisation. Based on the sources the relevant issues were synthesised in order to enable a conclusion on the research problems.

1.8 Chapter outline

Chapter 1 provided background information on debt capitalisation as well as the recent tax focus thereon. The chapter also highlighted the main problem statement and research questions to be addressed in the study, the research objectives and research methodology, as well as any limitations on the scope of the study.

Chapter 2 will consider whether issuing shares, in direct settlement of debt, will constitute an amount 'applied as consideration' as contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. As part of the investigation, BPRs issued by the SARS dealing with debt capitalisation through the direct issue of shares will be analysed. The analysis is performed to identify specific reasons for the ruling of the SARS as well as any similarities or anomalies in the rulings to establish whether debt capitalisation through direct settlement results in a 'reduction amount'. In chapter 2, the relevance of the findings in *CIR v Datakor Engineering* in the context of the current debt reduction regime contained in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act will also be addressed.

In **Chapter 3,** set-off as a method of debt capitalisation will be considered. The requirements and challenges for set-off to be applied in debt capitalisation will be investigated. Based on this investigation, a conclusion will be reached on whether set-off would result in a 'reduction amount' contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. Furthermore, BPRs issued by the SARS, dealing with debt capitalisation through set-off will be analysed. The analysis is conducted to identify specific reasons for the ruling of the SARS as well as any similarities or anomalies in the rulings to establish whether debt capitalisation through set-off results in a 'reduction amount'.

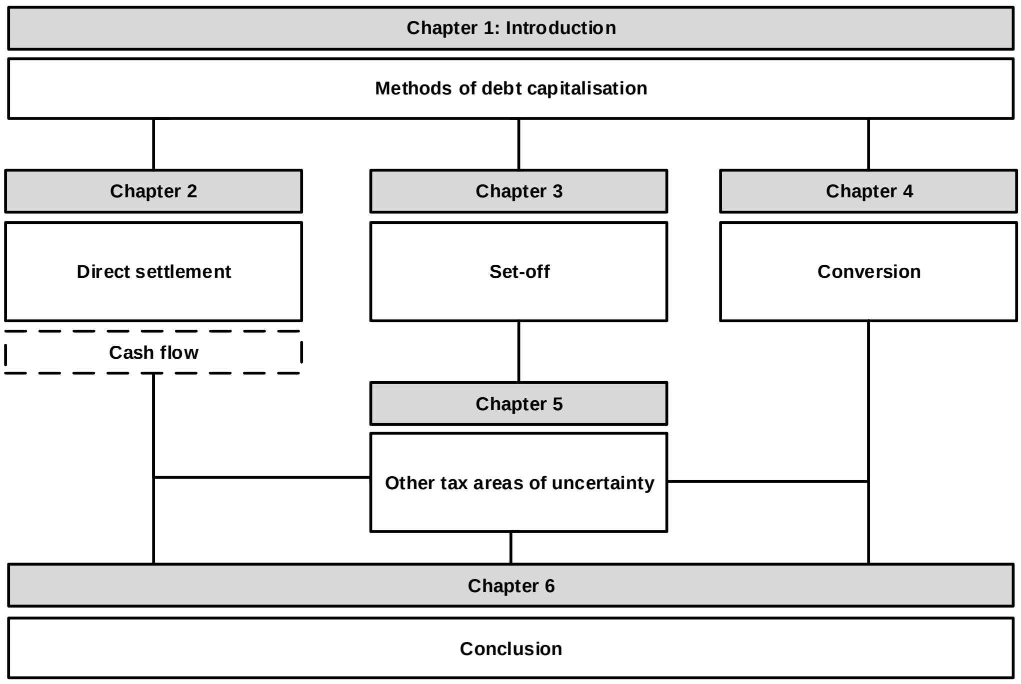
In **Chapter 4**, the conversion of debt instruments into equity and the resulting capitalisation of debt instruments will be considered. As part of this consideration, BPR 246 issued by the SARS on the capitalisation of debentures will be analysed to establish if capitalisation of debt instruments may result in a ‘reduction amount’. It will be concluded on whether the fulfilment of the conversion rights attaching to debt instruments amount to a ‘reduction amount’ as contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act.

Chapter 5 considers other areas of uncertainty in the law of taxation in respect of debt capitalisation not dealt with as part of the primary research questions. The uncertainties identified deal principally with proposed legislative amendments to debt capitalisation, as well as policy and administrative matters that have emanated from the literature study. However, although a critical analysis and specific conclusion on these areas of uncertainty are outside the scope of the study, relevant considerations are highlighted in order to provide a more in-depth perspective on debt capitalisation, beyond the current normal tax consequences thereof.

Chapter 6 summarises the research findings with reference to the primary research questions. A conclusion will be made on whether shares issued in the reduction of debt, in its various forms, results in the application of the tax consequences of section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. The chapter concludes with closing remarks and recommendations relating to debt capitalisation as well as suggests further areas for research.

The chapter outline is illustrated in the following figure, with reference to the different methods of debt capitalisation:

Figure 1.3: Chapter outline



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Further references in this study to ‘section’ are to sections of the Act and references to ‘paragraph’ are to paragraphs of the Eighth Schedule to the Act, unless specifically stated otherwise.

CHAPTER 2
ISSUE OF SHARES IN DIRECT SETTLEMENT OF DEBT

2.1 Introduction

Issuing shares in direct settlement of debt, or utilising cash flow to achieve the outcome, appears to be one of the preferred methods of debt capitalisation in South Africa. This is based on the fact that the majority of Binding Private Rulings (‘BPRs’) issued by the SARS on debt capitalisation propose to be conducted through direct settlement or utilising cash flow. This chapter will critically analyse the defined term ‘reduction amount’ in order to determine whether issuing shares in direct settlement of debt (or through cash flow) would result in a ‘reduction amount’ in respect of which the debt reduction regime applies. Du Plessis (2002:204) indicates that definition clauses in legislation as interpretative aids call for interpretation themselves. For this reason, analysing relevant words and phrases within the defined term ‘reduction amount’ is necessary. The analysis will be performed by considering the Act itself, the ordinary meaning of the words or phrases, case law, as well as the Companies Act 71 of 2008 (‘the Companies Act’).

The term ‘reduction amount’ is defined in both section 19 and paragraph 12A and the same definition applies in both instances:

> ***“reduction amount”**, in relation to a debt owed by a person, means any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction.*

Visser (2014:1) suggests that section 19 and paragraph 12A will apply when debts are capitalised in exchange for shares (specifically preference shares) “because ***no amount has been applied*** as ***consideration*** against the debt” (own emphasis). Therefore, in order to determine if debt capitalisation could potentially amount to a ‘reduction amount’, a twofold examination is required:

(i) Firstly, does issuing shares by a debtor company amount to an ‘amount applied’ by that company for the reduction of debt? This requires an analysis of the term ‘amount applied’; and

(ii) Secondly, does the waiver or forbearance of a right to claim payment by the creditor in exchange for the issue of shares by the debtor company, amount to ‘consideration’? This requires an analysis of the term ‘consideration’.

An analysis of these two terms will assist in the interpretation of what a ‘reduction amount’ constitutes and whether debt capitalisation by means of direct settlement would result in a ‘reduction amount’.

2.2 Binding Private Rulings: Direct settlement and cash flow

One of the matters that give rise to the uncertainty of whether debt capitalisation may result in a ‘reduction amount’ to which the debt reduction regime applies, is the number of taxpayers that have approached the SARS to issue BPRs on proposed debt capitalisation transactions using direct settlement. An evaluation of these BPRs is necessary, in order to establish whether:

- there are specific reasons for the SARS to issue a ruling on whether or not debt capitalisation through direct settlement results in a ‘reduction amount’;
- there are any similarities in the BPRs that can provide guidance on whether or not debt capitalisation through direct settlement gives rise to a ‘reduction amount’; and
- there are any anomalies in the BPRs that can provide guidance on whether or not debt capitalisation through direct settlement gives rise to a ‘reduction amount’;

Table 2.1 summarises the BPRs that have been issued by the SARS. This summary is followed by the main findings from the BPRs.

Table 2.1: Summary of Binding Private Rulings dealing with capitalisation through direct settlement

BPR	Debtor	Creditor	Transaction	Cash flow required	Specific ruling on debt reduction
124 (22 October 2012)* * Ruling issued prior to the introduction of section 19 and paragraph 12A (ruling considered in terms of the now repealed section 20(1)(*a*)(ii) and paragraph 12(5))	A private company incorporated in and a resident of South Africa	A private company incorporated in and a **resident** of South Africa	Proceeds from the issue of redeemable **preference shares** used to repay outstanding **shareholder** loans in order to improve the solvency of the company and to reduce the interest burden on the company	Yes	No concession or compromise. Section 20(1)(*a*)(ii) and paragraph 12(5) not applicable
173 (2 July 2014)	A company incorporated in and a resident of South Africa	**Foreign company** (not resident in South Africa)	Proceeds from the new issue of **ordinary shares** will be used to repay outstanding **shareholder loan**. The subscription price in cash is equivalent to the amount of the outstanding loan.	Yes	Section 19 and paragraph 12A not applicable
208 (8 October 2015)	A company incorporated in and a resident of South Africa	A company incorporated in and a **resident** of South Africa	Proceeds from a nominal **ordinary share** issue and **share premium** used to repay **shareholder** loan	Not required by the SARS, but proposed by the applicants	Section 19 and paragraph 12A not applicable

BPR	Debtor	Creditor	Transaction	Cash flow required	Specific ruling on debt reduction
213 (17 December 2015)	A company incorporated in and a resident of South Africa	**Foreign company** (not resident in South Africa)	Proceeds from the new issue of **ordinary shares** will be used to repay outstanding **intercompany** loans (capital and **interest**)	Not required by the SARS, but proposed by the applicants	Section 19 and paragraph 12A not applicable to capital or interest repayments

Author compiled from the following sources:

SARS, 2012

SARS, 2014

SARS, 2015b

SARS, 2015c

The general distinction in section 1 between different types of shares are between 'equity shares' and shares that do not carry the right to participate in dividends and a return of capital beyond a specified amount. This distinction between different types of shares in terms of the Act is a relevant consideration in other areas of the Act. Section 42, for example, allows that only equity shares (as defined in section 41) can be issued in the execution of an asset-for-share transaction. In the BPRs, however, the SARS has not followed a consistent distinction and terminology to what is used in the Act. The SARS has allowed that both 'ordinary shares' and 'preference shares' be issued as part of debt capitalisations. The type of shares and the combination in which the shares are issued as part of the same capitalisation transaction, in respect of the same debt, should therefore not lead to a 'reduction amount'.

In BPR 124 and BPR 173 the SARS required that the debt capitalisation be executed using cash flow (SARS, 2012; SARS, 2014). In the more recent BPR 208 and BPR 213 the applicants proposed to implement the transaction using cash flow, but the SARS did not make this a specific condition when issuing the ruling (SARS, 2015b; SARS 2015c). Whether the SARS did not explicitly make the ruling subject to this requirement because of the applicants' indication that they will use cash, or if the SARS does not require cash to be used, is unsure. The fact that the SARS (2016c:11) does recognise direct settlement without referring to cash flow, is indicative that a lack of cash in the execution of debt capitalisation should not lead to a 'reduction amount'.

The SARS has allowed that not only the capital portion of debt, but also capitalised interest, be capitalised. This is arguably due to the fact that contractual interest, when capitalised, also becomes a 'debt' in respect of which section 19 and paragraph 12A may be applicable. However, National Treasury is not in favour of allowing capitalised interest to be converted into equity. In the 2017 Tax Policy and Administrative discussion document, National Treasury (2017a:139) indicates that although it is proposed that the conversion of debt into equity be allowed, capitalised interest will still be recouped on the debt in respect of which an interest deduction was previously claimed when debt capitalisation is done. This has led to the inclusion of section 19A in the Draft debt reduction provisions. In terms of the draft section, a debtor will recoup any interest deducted in the year of assessment of the debt capitalisation and the preceding five years of assessment (draft section 19A(1)). The amount recouped will be the extent to which the interest was allowed as a deduction from taxable income in the hands of the debtor company and was not subject to normal tax in the hands of the creditor. The recoupment will first reduce any balance of assessed loss, after which a third of the excess will be recouped in the three years immediately following the debt capitalisation (draft section 19A(2)).

BPR 208 distinguishes between shares issued at a nominal value and shares issued at a premium. The creditor subscribed for shares at a share premium equal to the face value of the debt. The distinction between the nominal value of shares and shares issued at a premium is relevant in the context of the debtor company's contributed tax capital ('CTC'). The concept of CTC in the Act, as defined in section 1, was deemed to have come into operation on 1 January 2011. CTC comprises the sum of stated capital or share capital and share premium before 1 January 2011 and the consideration received by or accrued to a company for the issue of shares on or after 1 January 2011. Although not specifically indicated in BPR 208, a reasonable conclusion can be made that since all consideration received by the debtor company will form part of its CTC for future purposes, the distinction between share capital and share premium is not relevant for tax normal purposes. The applicants were therefore allowed to structure the debt capitalisation in such a way that it included both share capital and share premium. This is similar to the *CIR v Datakor Engineering* judgement where the shares received by third-party creditors were issued at a premium. A distinction between share capital and share premium for shares issued as consideration for debt capitalisation, does therefore not lead to a 'reduction amount'.

All of the BPRs dealing with direct settlement through cash flow have indicated that section 19 and paragraph 12A will not be applicable in the circumstances. However, the rulings do not elaborate on any technical or legal analysis of why this is the case. Despite the lack of specific guidance, some of the characteristics that have been identified can be used in the interpretation of a 'reduction amount', specifically relating to the practical implication of debt capitalisation. This is mainly because the purpose of BPRs are to provide clarity and certainty on how the SARS interprets various tax provisions (SARS, 2013:1). Observations such as the distinction between share capital and share premium and the treatment of capitalised interest demonstrates the SARS's pragmatic and practical approach to debt capitalisation in ruling that section 19 and paragraph 12A are not applicable to the specific transactions. This suggests that debt capitalisation through the direct issue of shares does not result in a ‘reduction amount’.

Despite the guidance obtained through an analysis of the BPRs, it remains uncertain whether debt capitalisation through the direct issue of shares would result in a ‘reduction amount’. This uncertainty is the result of the nature and effect of BPRs. BPRs are merely an indication of the SARS’s interpretation of the relevant tax provisions (SARS, 2013:3), and even in such a case, without providing reasons for the specific interpretation. The SARS’s interpretation of tax legislation has therefore not been confirmed through any legal precedent. In terms of section 82(2) of the Tax Administration Act 28 of 2011, as amended (‘the Tax Administration Act’), BPRs do not have a binding effect on the SARS unless a person was an applicant to the ruling. Section 82(4) of the Tax Administration Act furthermore indicates that a BPR may not be cited in any proceedings (including court proceedings) if a taxpayer was not an applicant to the ruling. As a result, there is no certainty that the SARS will hold the same interpretation of the law to a different set of facts than applied to a specific ruling. The SARS (2013:43) indicates that there are two reasons that a taxpayer cannot rely on a BPR that has been issued to someone else, even if the facts of the ruling are similar to those of the taxpayer. Firstly, many BPRs are in respect of time-sensitive transactions. Secondly, BPRs are particularly fact specific. BPRs generally do not include all the facts relevant to the ruling and even minor differences can result in a critical difference of interpretation. Therefore, although the BPRs may be considered as interpretative aids, they cannot serve as definitive conclusions. As such, it is necessary to further evaluate whether debt capitalisation through the direct issue of shares would result in a ‘reduction amount’, by critically analysing the terms ‘amount applied’ and ‘consideration’.

2.3 The term ‘amount applied’

BPR 191 does not deal directly with debt capitalisation. However, the SARS was required in BPR 191 to rule on whether section 19 and paragraph 12A would be applicable to a transaction in which debt funding was refinanced through preference shares. The ruling therefore provides some insight into how section 19 and paragraph 12A could be interpreted. One of the matters that emanates from the ruling is whether an amount has been ‘applied’ towards validly discharging a debt when the debt funding is replaced with preference share funding (SARS, 2015e). In commenting on BPR 191, Lewis (2015:2) makes the assumption that the reason for the applicants in BPR 191 to approach the SARS to issue a ruling on the proposed transaction, was that a potential set-off of debts might lead to a failure in validly discharging debts. Therefore, the applicants proposed instead to implement the transaction through cash flow in order to avoid the potential negative tax consequences of section 19 and paragraph 12A, if it was found that the debt had not been validly discharged.

Van Niekerk (2015:46) advances a similar argument when considering the discharge of debts and indicates that the Act requires ‘consideration’ to be ‘applied’ for the issue of shares to reduce the amount of debt that will be subject to the debt reduction provisions. Van Niekerk (2015:46) also refers to Brincker (2011a) in his argument that a debtor does not discharge a loan obligation through the issue of shares. The arguments from Lewis (2015:2) and Van Niekerk (2015:46) regarding the discharge of debts have strong roots in legal precedent. Harms JA did not indicate in the *CIR v Datakor Engineering* judgement that cash flow is a requirement to legally discharge a debt, but did find that through debt capitalisation an enforceable obligation is replaced with something completely different, being a share. Consequently, Harms JA concluded that the capitalisation of debt amounts to a ‘concession’. From the latter conclusion it is suggested that replacing an enforceable obligation with something that differs in nature and in legal form, does not validly discharge the debt. This suggestion, made in the context of a preference share issue, is also relevant in the case of equity shares. If not even the issue of preference shares, which are more akin to debt than equity shares as a result of the rights attached thereto, discharges an obligation, then equity shares can hardly be said to have that effect. This is also in line with Van Niekerk’s (2015:46) conclusion that in instances where a debt has not been legally discharged, a valid argument can be put forward that ‘consideration’ has not been ‘applied’ against the debt. Therefore, to ‘apply’ an amount as ‘consideration’ requires that the debt should be validly discharged.

In *CIR v Datakor Engineering*, a debt was described by Harms JA as an enforceable obligation to pay. The SARS (2016c:7) indicates that a debt is reduced if the contractual obligation to pay attached to the debt is discharged. Furthermore, the SARS (2016c:7) contends that the discharge of an amount owed to a creditor using an applicable legal method will result in a reduction of a debt. Establishing if the issue of shares by the debtor as *quid pro quo* for the debt does indeed validly discharge the debt obligation is therefore necessary. Thomas, *et al* (2000:234-236) indicates that obligations can be discharged in various ways, including performance, release, *confusio*, set-off, novation, delegation and cession. There is sufficient support in case law that an obligation can indeed be discharged through the issue of shares. In the *CIR v Datakor Engineering* judgement, despite the fact that debt capitalisation was found to be a ‘compromise’, no finding was made that the issue of the shares did not discharge the debt. The finding by the Supreme Court of Appeal, in this instance, had no effect on the third-party debts that were capitalised and accordingly discharged. In *C:SARS v Labat Africa Ltd*, although the court concluded that the issue of shares does not constitute expenditure incurred, no finding was made that the issue of shares did not indeed discharge the debtor’s obligation towards the creditor. Again, the judgement did not have the result to reinstitute any obligation between the debtor and the creditor. Any obligations between the parties had been discharged through the issue of shares.

In tax legislation, the corporate rules in terms of section 42 make provision that a person can dispose of an asset to a company in exchange for the issue of shares. Had it not been for this provision, the disposal of the asset would have created an obligation between the debtor and creditor. However, the working of section 42 does not create such an obligation, possibly indicating that the Legislature accepts that the issuance of shares is sufficient to discharge a debtor’s obligation towards a creditor. The discharge of an obligation through the issue of shares is accepted commercially as well. For example, in the Competition Tribunal’s approval for the merger between Mvelaphanda Holdings (Pty) Ltd and Rebserve Holdings Ltd in 2004, Rebserve Holdings purchased certain assets from Mvelaphanda Holdings. The obligation so created was discharged by Rebserve Holdings by allotting and issuing of its shares to Mvelaphanda Holdings (Competition Tribunal of South Africa, 2004:1).

The Draft debt reduction provisions in section 19(8)(*e*) refers to debt that is *reduced or settled* by means of shares issued (National Treasury, 2017b:30). The draft section 19B also refers to debt that is *settled* by converting or exchanging it for shares in the debtor (National Treasury, 2017b:32). Through these draft proposals, the Legislature clearly accepts that a debtor’s obligation towards a creditor can be discharged through the issue of shares. Accordingly, the issue of shares by a debtor company can indeed be used to validly discharge a debt towards a creditor. Although the issue of shares validly discharges a debt, the form (cash flow or merely through book entries) and the market value of the share issue may potentially affect the conclusion of whether the issue of shares in exchange for the release from an obligation to pay a debt results in a ‘reduction amount’. Establishing whether there is a requirement for cash to be used in the execution of debt capitalisation as well as concluding on the market value of the shares issued during debt capitalisation is therefore necessary. These two aspects are considered in more detail in sections 2.3.1 and 2.3.2.

2.3.1 The cash flow requirement

In practice, the question of whether or not to use cash for debt capitalisation is a very relevant consideration. Not only are there significant costs and risks associated with a cash transaction (for example the use of bridge financing), but there may also be regulatory requirements that need to be adhered to when applying cash. The South African Reserve Bank, for example, has reportable transactions that require authorised dealers to record cross-border transactions with the Financial Surveillance Department (South African Reserve Bank, 2017:1). Considering whether there is a requirement to apply cash flow in the direct settlement of debt through a share issue is therefore relevant. Stated differently, it needs to be established if the discharge of the debt through a share issue may still result in a ‘reduction amount’ if cash is not applied to conclude the transaction. Although the same outcome is achieved, whether or not cash is used, different tax consequences could potentially be attached to the transaction based on the chosen method. In this regard, Van der Zwan (2014:1) refers to the following extract from the *C:SARS v Labat Africa Ltd* judgement:

> *The fact that the parties may have constructed their agreement differently and tax-efficiently is entirely beside the point.*

Applying cash in a debt capitalisation transaction could therefore result in different tax consequences when compared to a transaction involving direct settlement through book entries. The different transaction steps that could provide different tax outcomes with direct settlement is illustrated in Table 2.2:

Table 2.2: Transaction steps for debt capitalisation through direct settlement

Direct settlement	Cash flow
Journal entry 1 in the records of debtor:	
Dr Debt liability Cr Share capital	Dr Cash Cr Share capital
Journal entry 2 in the records of debtor:	
None	Dr Debt liability Cr Cash

Author compiled

From the transaction steps and journal entries illustrated in **Table 2.2** it is evident that although
the same outcome is achieved, there is a clear distinction between using cash in direct settlement as opposed to using merely book entries. Hence, it is necessary to evaluate the need for cash in direct settlement. The SARS (2015d:122) states that debenture holders will receive consideration when the market value of shares issued by a debtor company when repaying debentures, equals or exceeds the face value of the debentures. In this regard, the SARS (2015d:122) indicates the following:

> *The execution of the transaction by book entry does not alter this fact, although it may well result in a recoupment in the company's hands …*

With reference to the requirement for cash flow during debt capitalisation, Van der Zwan (2014:2) argues that introducing cash flow into a transaction would not disguise the true effects of the transaction for normal tax purposes. Van der Zwan (2014:2) makes this comment with reference to the suggestion by the SARS that "South African courts have not always taken kindly to cheque-swapping antics". There are accordingly conflicting views expressed by the SARS on whether cash flow is required when concluding transactions. On the one hand the SARS indicates that the execution of a transaction through book entries alone may have negative tax consequences and on the other hand it states that mere 'cheque swapping' is also not sufficient. How courts will interpret the cash flow requirement remains uncertain. Marais (2013:8) summarises the current perception of the Judiciary's requirement for cash flow as follows:

> *It is nevertheless unfortunate that, in recent times, there seems to be a perception that the courts tend to approach transactions formalistically … by seemingly looking only to the form of transactions, by requiring cash flows to have occurred.*

In line with Van der Zwan's (2014:2) contention that introducing cash flow to a transaction would not disguise the true effects of the transaction for tax purposes, the answer to the cash flow debate may be found in the common law principle of substance over form, or the *plus valet* doctrine. According to this principle, the law has regard for the substance of a transaction, rather than its form (Cassidy, 2012:322-323). Therefore, courts will consider whether transactions are consistent with the parties' real intention, or whether the form of the transaction is intended to disguise the true nature of the arrangement and therefore represents a simulation. Struwig (2013:18), with reference to Christie (2001:396), describes a simulated transaction as a transaction where parties seek to achieve a predetermined objective on which a statute may impose some form of burden, but through design of the transaction they still achieve the desired outcome by concealing certain elements that may be susceptible to the imposing statute. PricewaterhouseCoopers (2014:1) suggests that the judgement in *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC & Others* (2014) ZASCA 40 confirms that the essence of a simulated transaction is that the transaction is not genuine. They concluded that if a transaction is indeed genuine, then the court will give effect to it.

The substance over form principle is used in most cases to contend transactions entered into by taxpayers on the basis that the arrangement may constitute tax avoidance. There should, however, be no reason why the doctrine should not be equally applied in cases where taxpayers conclude transactions in a particular way, which give effect to the substance of the transaction and to the parties' true intention. If the true substance of the transaction is to issue shares in exchange for the release from an obligation to pay a debt, then introducing cash into the transaction just to ascribe to a certain form would be considered to be redundant. If, as PricewaterhouseCoopers (2014:1) suggests, a court will give effect to a genuine transaction, there should be no reason why debt capitalisation through the direct issue of shares should have a different outcome in tax than a transaction that achieved the same result through the application of cash flow. If the true substance of the transaction and the parties' intention is to capitalise and extinguish the debt in exchange for shares, there should be no reason why cash flow is required to execute the transaction. The latter finding is in line with Van der Zwan's (2014:2) comment that the capitalisation of a loan, with or without cash flow, should not result in a reduction for purposes of section 19 and paragraph 12A if the value of the shares issued is equal to the amount of the debt reduced. The finding is also aligned with the Draft debt reduction provisions. In the draft sections 19(8)(*e*) and 19B, the Legislature proposes to provide relief from the reduction of intra-group debt when debt is reduced or settled *directly or indirectly*. In addition to referring to direct or indirect methods of debt capitalisation, the draft section 19B also specifically includes using the proceeds from a share issue to capitalise debts. The fact that the proposed section includes cash flow as well as other direct and indirect methods of capitalisation, is a strong indicator that cash flow is not an absolute requirement for debt capitalisation to not constitute an 'amount applied'.

Having established that debt can be validly discharged through the issue of shares and that there is no requirement to use cash flow in such a transaction, an enquiry into the market value of the 'amount applied' is necessary to determine if this could possibly have an impact on the question of whether or not the issue of shares constitutes an 'amount applied'.

2.3.2 The value of the 'amount applied'

An enquiry into the value of the 'amount applied' is necessary to establish if the market value of the 'amount applied' may have a bearing on whether or not debt capitalisation could result in a 'reduction amount'. The SARS (2015d:140) recognises this distinction and refers to the following values which are subsequently discussed:

- 'Market value' of shares;
- The subscription price for shares; and
- The 'face value' of debt.

The market value of shares is a complicated matter as result of valuation which can be controversial and subjective (PricewaterhouseCoopers, 2017:1). Cornelius (2013:872) indicates that it is trite law that market value is a question of fact, which must be proven by presenting relevant evidence. Cornelius (2013:872) also quotes Kumleben JA who in *Sarembock v Medical Leasing Services (Pty) Ltd* (1991) SA 344 (A) indicated that:

> *[as] a general rule the value of an article is to be determined with reference to the price it would fetch in the open market ... However ... [t]here may be cases where, owing to the nature of the property, or to the absence of transactions suitable for comparison, the valuator's difficulties are much increased.*

When the market value of shares to be issued in a debt capitalisation transaction are determined, the difficulty is that there is often not a market with a willing buyer and willing seller to dictate the price at which shares and debt can be traded. This is mainly due to the fact that in many cases where debt capitalisation occurs, transactions are concluded between related parties. Unless as part of a scheme of arrangement in terms of the Companies Act, or a similar business rescue operation, the true value of related-party debt, and consequently the shares, may be very difficult to determine. A related-party creditor may therefore have a significant debt claim against a debtor company, but the claim may be worthless in the hands of an unrelated party. This can be due to a variety of factors, including the solvency and liquidity of the debtor, its future prospects or the industry in which the debtor operates. This is substantiated by Sweeny's argument that there is a contrast between the market value of debt and the book value of debt that is the result of a lack of public quotes for debt and the fact that that debt trades infrequently (Sweeny, et al., 1998:53). This anomaly in market value opens up debt capitalisation to potential abuse. Parties may argue that the debt that is capitalised and shares subsequently issued have no market value, since no unrelated party will be willing to purchase the debt at face value and through this manipulate the value and number of shares issued. A possible solution for this may be found in a reference by Cornelius (2013:873) to Wessels JA in *Katzenellenbogen Ltd v Mullin* (1977) 4 All SA 818 (A), where the judge indicates that the phrase 'current value' may sometimes be more appropriate than the phrase 'market value'. When there is no active market which can determine the value of shares, the current value, or book value, may be more appropriate to determine whether there is potentially a 'reduction amount' when the debt is capitalised.

When considering the market value of shares issued in a capitalisation transaction, the point in time at which such market value is determined is also an important factor, being either before the capitalisation or thereafter. In cases where shares are listed on a recognised exchange and the market value is determined by market forces, or where the creditor whose debt is capitalised is already the sole holder of shares of the debtor company, this is less of an issue. However, when valuations are performed with reference to only values included in the statement of financial position (as opposed to complex valuation models), or where new parties become holders of shares, this becomes a very relevant consideration. Since debt capitalisation removes debt from the liabilities section of the statement of financial position to equity and therefore improves the net equity position, the market value of issued shares should in theory increase along with the improved solvency. Shares in the debtor company should therefore be worth more after debt capitalisation than prior to it. This fluctuation in the market value of shares will in turn determine the number of shares that should be issued to a creditor in exchange for the capitalisation of debt, which will affect the effective interest of the creditor after debt capitalisation.

It is submitted that the market value of the shares should be considered after the capitalisation has been completed for the following reasons:

(i) Both sections 24BA(3) and 40CA, dealing with the issue of shares in exchange for the acquisition of assets, requires a market value determination after shares have been issued. This is an indication that the Legislature requires that the effective position of the creditor should be evaluated after the transaction has been concluded;

(ii) In many cases, an evaluation of the market value of shares prior to debt capitalisation would be irrational. This would be the case where the debtor company is insolvent (in other words, the debtor has negative equity); and

(iii) Where valuations indicate, for whichever reason, that the market value of shares prior to debt capitalisation are effectively worthless or only worth a nominal amount. In such instances, determining the market value of the shares prior to debt capitalisation would be unreasonable.

With reference to the subscription for shares, a distinction between the purchase price of shares and the subscription price is necessary. A subscription involves the issue of new shares and the proceeds of those shares to be received by the company that issued those shares (Parker, 2016:1). The subscription price is a crucial consideration from a Companies Act perspective, as section 40 of the Companies Act requires adequate consideration to be received for the issue of shares. With debt capitalisation, however, the market value of the shares, being the ‘amount applied’, and the face value of the debt are compared to establish whether a ‘reduction amount’ has resulted. Although in most instances the subscription price would be equal to the face value of the debt (the face value of the debt being the *quid pro quo* for the issue of shares) the subscription price is of less importance from a taxation point of view. In support of this, the SARS (2015d:140) has used examples where, despite the value of the subscription price, a ‘reduction amount’ has either resulted or not resulted due to the comparison between the market value of the shares and the face value of the debt.

Apart from excluding a tax debt (as defined in section 1 of the Tax Administration Act), the Act does not provide any further guidance within the definition of debt, as defined in section 19 and paragraph 12 A on the meaning of ‘debt’ or the ‘face value’ of debt. National Treasury (2012:31) defines debt to be:

> *Debt encompasses a sum owed by one party (the debtor) to another party (the creditor). Typically, a debt is created when the creditor lends a sum of money to a debtor. The debt is granted with expected repayments that may (or may not) include interest for the use of the sums loaned. Debt can come in many forms, including a personal loan, an advance (e.g. on salary), a note, a bond, a debenture, a bank deposit or any other claim of money requiring repayment.*

Despite the fact that debt has a market value when traded, there is no indication in the Act or the definition from National Treasury (2012:31) that the tax consequences of debt should be determined with reference to its market value. Since the term is not defined and its ordinary grammatical meaning should be ascribed to it, the face value of debt should only mean the amount that is due by the debtor to the creditor. This amount, when measured against the market value of the shares issued, should be the base line for determining whether a ‘reduction amount’ has resulted when debt is capitalised. The next discussion considers the consequences where the market value of the shares issued differs from the face value of the debt in order to establish if a difference between the two values may result in a ‘reduction amount’. In this context, the potential application of section 24BA is also considered in more detail.

2.3.3 Difference between market value of shares and the face value of debt

In commenting on the *CIR v Datakor Engineering* judgement, Visser (2014:1) argues that when debt is capitalised the conversion of the debt into shares (specifically preferences shares in this case) results in a dilution of the creditor's rights. This, Visser (2014:1) suggests, could result in a lower value to be attributed to the shares than to the face value of the debt. Consequently, this will lead to a mismatch in the value of the *quid pro quo* received for the face value of the debt. Van Reenen (2015:14) supports the argument and concludes that this is in line with the view expressed by the SARS (2015d:140), that although it is possible that a subscription price for shares may be greater than the market value of the shares issued, a 'reduction amount' can still arise if the market value of the shares is less than the face value of the debt.

This argument has support in case law. In *CIR v Datakor Engineering* Harms JA concludes that the Act is not concerned with the benefit received by the creditor, but with the benefit received by the debtor. Therefore, Harms JA discarded the argument by the respondent that it may be that the shares are worth more than the subscription price, in which event the creditors relinquished nothing. In oder to establish if a concession has been made it would be required to link the market value of the shares back to the face value of the debt. Although, based on the facts, Harms JA found fault with the reasoning by the court *a quo*, it is worth noting that a concession resulted from the debt capitalisation on the basis that the creditors received something less than the face value of their debt. The face value of the debt is therefore the measure against which other values are compared in order to establish whether or not debt capitalisation results in a 'reduction amount'. If the 'amount applied' as 'consideration' for the issue of shares is therefore less than the face value of the debt, only the market value of the shares issued in exchange for the debt would qualify as an 'amount applied'. When the market value of the shares issued during capitalisation exceeds the face value of debt, no 'reduction amount' should arise (SARS, 2015d:140).

In terms of section 19 an paragraph 12A, the debtor is required to include any recoupment as a result of a 'reduction amount' in its taxable income in the year of assessment in which the 'reduction amount' arises. The draft section 19B proposed by the Draft debt reduction provisions postpones any adverse tax consequences as a result of a mismatch between the face value of the debt and the market value of the shares issued, for as long as the debtor and creditor remain part of the same group of companies. If the debtor and creditor remain part of the same group of companies for at least five years after the year of assessment during which the debt capitalisation was concluded, no further tax consequences in respect of the mismatch will be applicable. Thus, permanent value mismatches without tax consequences will therefore be possible between debtors and creditors. However, the relief will only be applicable in the specific circumstances described by the proposed section 19B. Until such time that the proposal is legislated, as well as in respect of debtors and creditors who do not meet the requirements of the draft section 19B, the tax consequences of a value mismatch remain relevant. Despite providing immediate relief from a 'reduction amount' in certain circumstances, the Draft debt reduction provisions do not contain any indication of the interaction of the proposals to section 24BA, dealing with value shifting.

Section 24BA is an anti-avoidance provision aimed at value-shifting arrangements (Lewis, 2014:1). The application of section 24BA is very specific, in that the section requires an 'asset' (as defined in paragraph 1) to be acquired by a debtor in exchange for the issue of shares. Had it not been for the specific requirement that an 'asset' as defined in the Eighth Schedule should be acquired then, possibly, the debtor's release from an obligation to pay a debt to a creditor could have been made equivalent to acquiring an 'asset'. However, the main terms in the definition of 'asset' in paragraph 1 are 'property' and 'a right'. The SARS (2015d:39) describes 'property' as "anything that can be disposed of and turned into money". 'A right' includes both personal rights and real rights that can be enforced against a particular person or group of persons (SARS, 2015d:43). Given the strict interpretation of the phrases 'property' and 'a right' as part of the definition of 'asset', a release from an obligation to pay would not resort under the definition of 'asset' as the debtor does not acquire a right enforceable against another party but is rather released from an obligation towards the creditor. Therefore, when debts are capitalised through direct settlement, no 'asset' is acquired by the debtor company for section 24BA to be applicable. When the cash alternative is applied, the initial cash consideration by the creditor is for the subscription of the shares, which also does not equate to the 'acquisition' of an 'asset'. In the case of direct settlement and cash flow, value-shifting is addressed through the market value of the shares issued. If the market value of the shares is less than the face value of the debt, only the market value of the shares issued in exchange for the debt would qualify as an 'amount applied' and any excess of the face value would be regarded as a 'reduction amount'.

In answering the question of whether the direct issue of shares in exchange for the waiver of a right to claim payment of a debt amounts to an 'amount applied' as 'consideration', the first question into the examination has been answered in the affirmative. Based on an analysis of the term 'amount applied' the study has found that debt is validly discharged by a debtor company through the issue of shares. In this regard, the conclusion was reached that no cash flow is required to execute the transaction based on the *plus valet* doctrine. The value of the shares issued remains a relevant consideration, as only the market value of shares issued would constitute an 'amount applied'. Shares issued with a market value of less than the face value of debt would still result in a 'reduction amount' in respect of which section 19 and paragraph 12A are applicable. The second part of the investigation considers if the waiver or forbearance of a right to claim payment by the creditor amounts to 'consideration' received by the debtor company, which is subsequently considered in more detail in section 2.4.

2.4 The term 'consideration'

The term 'consideration', as used within the definition of 'reduction amount', is not formally defined in the Act. Therefore, the starting point will be to consider the ordinary meaning of 'consideration'. When a word is an ordinary English word or phrase and is not defined in the Act, its ordinary meaning must be attributed to it, unless the context indicates otherwise (*C:SARS v Labat Africa Ltd*, 2011). In the interpretation of statutes, dictionaries may be consulted to determine the ordinary meaning of words and expressions and courts often use this aid (Du Plessis, 2002:200). The SARS (2015d:139) also refers to dictionaries when considering the meaning of words. In the case of the word 'consideration', the SARS (2015d:139) refers to Oxford Dictionaries 2017 (online) that defines consideration to be:

> *2. A payment or reward…*
> *2.1 Law (In a contractual agreement) anything given or promised or* ***forborne*** *by one party in exchange for the promise or undertaking of another.* [own emphasis]

The Merriam-Webster dictionary (2017), in turn, defines the ordinary meaning and legal meaning of ‘consideration’ as respectively:

> *the inducement to a contract or other legal transaction; specifically: an act or* ***forbearance*** *or the promise thereof done or given by one party in return for the act or promise of another* [own emphasis]; and
>
> *something (as an act or* ***forbearance*** *or the promise thereof) done or given by one party for the act or promise of another* [own emphasis]

The SARS (2015d:77) quotes the Shorter Oxford English Dictionary on Historical Principles (Stevenson, 2007) on the meaning of ‘forbearance’ as abstinence from enforcing what is due, especially the payment of a debt. The term ‘forbearance’ therefore clearly includes a situation where the creditor offers the debtor release from its obligation to pay. The creditor gives, and the debtor company accepts, a forbearance of payment of the underlying debt in exchange for the issue of the shares by the debtor company. The amount of debt reduced or forborne therefore constitutes the ‘consideration’ for the share issue.

In analysing the dictionary meaning of ‘consideration’, the ordinary meaning clearly does not only include positive performance in the form of something given or done. The ordinary meaning also allows for an interpretation of something forborne in exchange for something else. The ordinary meaning of ‘consideration’ therefore includes the forbearance of a right. In the context of debt capitalisation, it is the creditor’s right to claim payment from the debtor that is forborne as *quid pro quo* for the shares issued by the debtor. Accordingly, there is nothing found in the ordinary meaning of ‘consideration’ that would exclude something other than payment or reward in the form of money to be offered as *quid pro quo* for a debt.

Apart from the ordinary meaning of ‘consideration’, the meaning that has been ascribed to the word in case law as well as in the context of the Companies Act is considered in more detail under 2.4.1 in the section to follow.

2.4.1 'Consideration' in terms of case law

In the absence of a defined word or phrase, turning to case law is often necessary to determine the meaning the courts will ascribe to an undefined word or phrase. According to Du Plessis (2002:128), this does most often not require a studious interpretative effort because of the normal rule of *stare decisis*, or precedent. In order to determine whether the meaning that courts have given to the word 'consideration', relevant case law is considered below.

In *CIR v Datakor Engineering*, the court had to deal with the issue of whether or not the capitalisation of third-party creditor debts in exchange for the issue of preference shares amounted to a 'concession' or 'compromise' given by the debtor company. Although Harms JA did not expressly consider the term 'consideration' or meaning thereof in his judgement, the word is used twice in the context of the waiver of debt in exchange for shares. In paragraph 3 of his judgement, Harms JA indicated with reference to the capitalisation of debt: "As *consideration* the concurrent creditors waived payment of these claims" and again in paragraph 11: "In *consideration* for a waiver of their claims the creditors received something different, namely shares" (own emphasis). The judge therefore seemingly accepted, without specifically ruling thereon, that the issue of shares amounts to 'consideration'.

In *C:SARS v Labat Africa Ltd*, the court was required to consider whether the issue of shares for the acquisition of a trade mark amounted to expenditure incurred by the taxpayer. In arriving at a conclusion, Harms AP made several references to the term 'consideration' and, in dealing with the issue, considered various other cases, both local and international. At the outset, when dealing with the agreement between the parties, the judge indicated that although the parties called the agreement a 'sale', this was in actual fact not accurate, because a 'sale' requires payment in money and not consideration *in kind*. Based on the latter indication it is evident that the issue of shares amounts to consideration, as the purchase price for the business was discharged through the issue of shares. The judge then turend to deal with the findings of the full court that resulted in the appeal. There, the court asked whether the issue of a company's own authorised shares in exchange for the trade mark represents real consideration given by the company. In answering this question, the court referred to an English case, *Osborne v Steel Barrel Co Ltd*, where the court found that the issue of shares for the acquisition of assets amounted to ‘consideration’ given by the company. This, Harms AP indicated is “hardly contentious”.

The court continued to consider two more English judgements. In *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd* (1982) 2 All ER 942 (HL), two findings from *Craddock v Zevo Financing Co Ltd* (1944) 1 All ER 566 (CA) were confirmed, of which one is relevant to the context of the study. The court found that a company can issue its own shares “as consideration for the acquisition of property”. Finally, Harms AP referred to *Lace Proprietary Mines Ltd v Commissioner for Inland Revenue* (1938) AD 267, where the court found that the true consideration for the acquisition of an asset was shares issued.

The judgements make it clear that when a creditor accepts consideration other than in money, for example, shares in the debtor in discharge of the obligation between the debtor and the creditor it amounts to ‘consideration’. The *Lategan v CIR* (1926) CPD 203 case also established the principle that a receipt or accrual for income tax purposes would include the monetary value of consideration received not in cash. Neither in *CIR v Datakor Engineering,* dealing directly with debt capitalisation, nor in *C:SARS v Labat Africa Ltd,* where an asset was acquired in exchange for shares issued, did the judgement alter anything relating to the discharge of the obligation between the parties that applied shares as consideration. The court accepted that the issue of shares amounts to ‘consideration’ for debt liabilities.

As issuing shares is a relevant transaction step in the execution of debt capitalisation, analysing what ‘consideration’ means in terms of the Companies Act, to establish if the meaning is aligned with the meaning in tax law, is necessary and discussed subsequently under 2.4.2 in the section to follow.

2.4.2 ‘Consideration’ in terms of the Companies Act

According to Du Plessis (2002:263), when interpreting statutes, having regard to the way in which a particular word or phrase is interpreted or defined in another contemporary act, is generally admissible. Considering what the term ‘consideration’ means in terms of the Companies Act, may not only helpful and appropriate, but also necessary. This is since the issue of shares in terms of the provisions of section 40 of the Companies Act is one of the key elements of a capitalisation transaction, being the *quid pro quo* for the release from payment of debt (SARS, 2015d:139).

The tax consequences of a ‘reduction amount’, for purposes of section 19 and paragraph 12A, should be considered from the perspective of the debtor (Van Reenen, 2015:13) who, in terms of a capitalisation transaction, will issue the shares. The debtor therefore has to *apply* an amount as ‘consideration’ for the reduction of debt when analysing the term ‘reduction amount’. In contrast, when considering the Companies Act, which governs the issue of shares, cognisance must be given to the consideration *accepted* by the debtor for the issue of shares in terms of section 40 of the Companies Act. Although applicable in both cases to the debtor company, the use of the word ‘consideration’ has a different context in the Act (for purposes of section 19 and paragraph 12A) as opposed to the Companies Act.

According to Weyers (2015:8), ‘consideration’ is widely defined in the Companies Act and there appears to be almost no restriction on the forms of consideration. In terms of section 40 of the Companies Act, the board of a company may authorise shares only, among others, for adequate consideration to the company. The Companies Act in section 1 defines ‘consideration’ to mean:

> *anything of value given and accepted in exchange for any property, service, act, omission or* ***<u>forbearance</u>*** *or any other thing of value, including-*
>
> *(a) any money, property, negotiable instrument, securities, investment credit facility, token or ticket;*
>
> *(b) any labour, barter or similar exchange of one thing for another; or*
>
> *(c) any other thing, undertaking, promise, agreement or assurance, irrespective of its apparent or intrinsic value, or whether it is transferred directly or indirectly;* [own emphasis]

Therefore, ‘consideration’ required for the issue of shares in terms of the Companies Act does not only include ‘anything of value given and accepted’ but also the ‘forbearance or any other thing of value’, including a negotiable instrument or promise, which should include any debt. From this analysis, the release from an obligation to pay clearly constitutes ‘consideration’ in terms of the Companies Act.

2.5 Overall conclusion

This chapter considered whether issuing shares, in direct settlement of debt, constitutes a ‘reduction amount’ as contemplated in section 19 and paragraph 12A. The investigation was conducted through an analysis of the terms ‘amount applied’ and 'consideration'. BPRs that have been issued by the SARS on debt capitalisation through the direct issue of shares were evaluated in order to establish if the rulings provide any guidance on the SARS interpretation of the relevant terms. None of the facts in BPRs issued resulted in the application of section 19 and paragraph 12A. Given the varying factual circumstances, the SARS appears to be pragmatic in its approach to ruling on the normal tax consequences of debt capitalisation through a direct issue of shares. However, the BPRs do not provide any definitive conclusion on the research question.

In analysing 'amount applied' the finding was made that issuing shares validly discharges a debtor's obligation towards a creditor. The conclusion was also reached that the principles of substance over form should be applied to debt capitalisation and that cash flow is therefore not a prerequisite for debt capitalisation to not constitute a 'reduction amount'. This finding is consistent with the view of the SARS that the issuing of shares directly to a creditor in full and final settlement of a debt constitutes consideration in a form other than in money (SARS, 2016c:11). A very complex yet relevant matter to consider, is the market value of the shares that are issued in discharge of the debt, as only the market value of the shares issued in exchange for the debt would qualify as an 'amount applied'. Any shares issued in discharge of the debt of which the market value is less than the face value of the debt will still result in a 'reduction amount'.

Based on a critical analysis of the term 'consideration', a finding was made that the issue of shares as *quid pro quo* for the release of an obligation to pay a debt amounts to 'consideration'. This conclusion is consistent with the findings in case law as well as in terms of the Companies Act. Having dealt with both the terms 'amount applied' and 'consideration' a conclusion could be reached on the first research question. Issuing shares in direct settlement of debt does not amount to a 'reduction amount', as contemplated in section 19 and paragraph 12A, if the market value of the shares issued exceeds the face value of the debt.

Finally, the relevance of the *CIR v Datakor Engineering* case, in terms of the current debt reduction regime contained in section 19 and paragraph 12A, should be evaluated, based on the ruling of Harms JA that an enforceable obligation is replaced with something of a completely different nature and Visser's argument (2014:1) relating to the market value of shares issued. It is submitted that the factors to determine the relevance of the *CIR v Datakor Engineering* case are found in the wording of section 19 and paragraph 12A as well as the question before the court in the *CIR v Datakor Engineering* case. In the judgement, the court had to decide if debt capitalisation amounts to “any benefit” received by the debtor resulting “from a concession granted by or a compromise made with his creditors” in terms of the now repealed section 20(1)(*a*)(ii) as it read at that time. The court found that debt capitalisation indeed did amount to a concession from which the debtor obtained a benefit. The court was not required to consider whether or not debt capitalisation constitutes ‘any amount applied’ against that debt as is required by section 19 and paragraph 12A. Section 19 and paragraph 12A on the other hand do not require an element of concession or compromise, or any benefit to the debtor as a result of such concession or compromise. The provisions merely require that *any amount* be applied as consideration for there not to be a ‘reduction amount’. The legal nature of the amount replacing the debt obligation and to what extent that amount bears similarities or differs in its enforceable rights to the original debt should not be relevant. Even though debt capitalisation may be considered to be a compromise or concession and the debtor does indeed benefit from that compromise or concession, this is not prohibited by section 19 and paragraph 12A. On the contrary, the Legislature’s intention may have been that a debtor should benefit from debt reduction (National Treasury, 2012:44).

The question then turns to the market value, in line with Visser’s (2014:1) argument that a different value can be ascribed to shares than to debt, presumably given their differences in legal nature. Visser (2014:1) argues in line with the conclusions of Harms JA that in the case of debts, all the assets of a company are available to satisfy the claims of creditors whereas, in the case of shares, only profits are available to distribute as dividends. As has been indicated in this chapter, determining the market value for any instrument can be a very complex matter. However, despite the complexity and the potential dilution of the creditor’s interest by having shares in the debtor as opposed to a debt claim, normal commercial considerations and negotiations can regulate the relative mismatch. If a creditor knows that a more liquid and enforceable debt claim will be capitalised, it could argue that a premium to the face value of the debt is warranted as the creditor will receive something in exchange that is more permanent, like share capital. Such a premium could take various forms, such as additional shares or a separate class of shares with more voting rights. The negative effect of the dilution of the creditor's interest due to debt capitalisation and the resulting reduction in the market value can as such be addressed, and that this should not prohibit the issuance of shares constituting an 'amount applied'. Based on this conclusion, the findings of *CIR v Datakor Engineering* is still relevant in terms of the current debt reduction regime contained in section 19 and paragraph 12A. This conclusion is despite the fact that no adverse tax consequences should arise under the current debt reduction regime when debts are capitalised through the direct issue of shares, as was the case in *CIR v Datakor Engineering*.

In **Chapter 3**, the second research question, relating to debt capitalisation through set-off will be considered in more detail, including the requirements and challenges for set-off in debt capitalisation.

CHAPTER 3
CAPITALISATION THROUGH SET-OFF

3.1 Introduction

Van Deventer (2016:1) indicates that set-off is a method by which obligations can be terminated without requiring the exchange of performances. Set-off operates where two parties are mutually indebted to each other and extinguishes obligations as effectively as if they have been discharged by performance (Van Deventer, 2016:1).

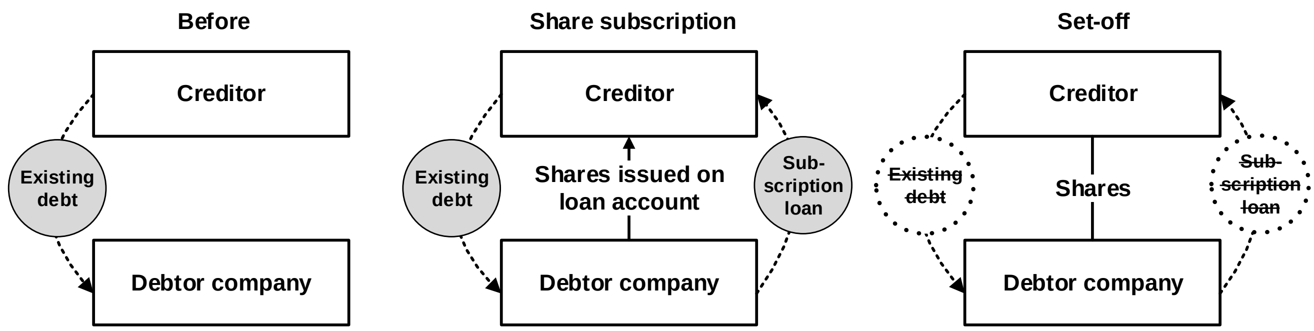
In *Ackermans Ltd v CSARS* 2010 (1) SA (SCA) 73, Cloete JA quoted from the initial objection by the appellant against an assessment raised by the Commissioner of the SARS:

> *[T]he parties allowed for set-off to operate … There is nothing sinister about such a contractual arrangement, it occurs in overabundance in commercial life.*

Despite the fact that the argument for set-off was not accepted by the court, the statement from the appellant in *Ackermans v CSARS* makes it clear that set-off is prevalent. Although set-off is recognised as a method in which obligations can be settled (Thomas, et al., 2000:235), it is one of the most complex areas in the South African law of obligations (De Kock, 2012:54). The SARS (2015d:140) notes that set-off may only be applicable in certain circumstances. Although the SARS does not elaborate on the specific circumstances, it can reasonably be assumed that set-off will only be applicable in cases where the legal requirements therefore are met.

For set-off to operate, there needs to be two parties that are indebted to each other and two obligations are required. A single obligation cannot be set off against an obligation that does not exist. Therefore, to use set-off in debt capitalisation, a second debt obligation is required. If two debts are not present, capitalisation should be done through a different method or a second debt should be established. Prior to a debt capitalisation transaction being executed only one debt exists, being the pre-existing debt that the debtor owes to the creditor. If the creditor is already a holder of shares in the debtor company, the shares that the creditor holds in the debtor is not an enforceable obligation that can be set off against debt, due to the different nature of debt and shares, as confirmed in *CIR v Datakor Engineering*. If there is no existing shareholder relationship, there is still only one obligation and set-off cannot be a valid method in which to execute debt capitalisation. The method that has been employed in practice to capitalise debt through set-off and create the second obligation, is that the creditor subscribes for shares in the debtor, but does not pay the subscription price in cash. The subscription price, which is left outstanding on loan account, creates the second obligation (the 'subscription loan') that is required for set-off to operate under appropriate circumstances. Evidence of this practice is found in BPR 193 and BPR 255 and is illustrated in figure 3.1:

Figure 3.1: Debt capitalisation through set-off



Author compiled

From **Figure 3.1** it is clear that debt capitalisation through set-off essentially consists of two separate transactions. Firstly, the creditor subscribes for shares in the debtor. As a second transaction step, the pre-existing debt and the subscription loan are set off. In the records of the debtor company, this can be illustrated by the example in **Table 3.1**:

Table 3.1 Transaction steps for debt capitalisation through set-off

Transaction 1: Share subscription	Transaction 2: Set-off
Journal entry in the records of debtor:	**Journal entry in the records of debtor:**
Dr Subscription loan asset	Dr Debt liability
Cr Share capital	Cr Subscription loan asset

Author compiled

This chapter investigates if debt reduction through set-off could result in a 'reduction amount', and analyse BPRs that have been issued by the SARS on debt capitalisation through set-off. The specific requirements for set-off, in the context of debt capitalisation, is also included in order to investigate whether existing debt is indeed capable of set-off and whether the two-step transaction approach meets the legal requirements for set-off.

3.2 Binding Private Rulings: Set-off

In line with the approach followed in Chapter 2 to consider BPRs issued by the SARS on a specific method of capitalisation, an evaluation of BPRs issued on capitalisation through set-off is necessary, in order to establish whether:

- there are specific reasons for the SARS ruling on whether or not debt capitalisation through set-off results in a 'reduction amount';
- there are any similarities in the BPRs that can provide guidance on whether or not debt capitalisation through set-off gives rise to a 'reduction amount';
- there are any anomalies in the BPRs that can provide guidance on whether or not debt capitalisation through set-off gives rise to a 'reduction amount';

Table 3.2 summarises the BPRs that have been issued by the SARS. This summary is followed by the main findings from the BPRs.

Table 3.2: Summary of Binding Private Rulings dealing with capitalisation through set-off

BPR	Debtor	Creditor	Transaction	Specific ruling on debt reduction
193 (15 June 2015)	A company incorporated in and a **resident** of South Africa.	**Foreign company** (not resident in South Africa).	Subscription loan, which consists of one **ordinary share** at par value as well as **share premium** (equal to the pre-existing loan plus interest), set off against the pre-existing debt. Before set-off occurs, the foreign company will demand payment of the debt.	Section 19 and paragraph 12A not applicable.
255 (30 November 2016)	A company incorporated in and a **resident** of South Africa.	A company incorporated in and a **resident** of South Africa.	The creditor will subscribe for **equity shares** in the debtor through a rights issue. The creditor will settle the subscription obligation by way of set-off against debt and capitalised interest. The pre-existing debt has no fixed terms of repayment and are payable on demand.	Section 19 and paragraph 12A not applicable.

Author compiled from the following sources:

SARS, 2015a

SARS, 2016b

As was the case with BPRs issued for capitalisation through direct issue discussed in Chapter 2, the SARS has taken a pragmatic approach to debt capitalisation through set-off. The type of shares issued, the tax residency of the creditor, the inclusion of capitalised interest and the distinction between share capital and share premium do not influence the SARS's ruling on whether or not debt capitalisation through set-off results in a 'reduction amount'.

Neither of the rulings issued in respect of set-off provide any further insight into the market value of the shares issued when the subscription loan was established, to consider the application of section 24BA. Although the SARS may reject a ruling if required to render an opinion on the market value of an asset (section 80(1)(*a*)(i) of the Tax Administration Act), there are indeed rulings that make reference to the market value of shares (for example BPR 241 issued on 13 June 2016). Since neither of the rulings deal specifically with section 24BA, it can be reasonably assumed the applicants did not specifically request the SARS to rule on section 24BA. Even though it was ruled in both instances that section 19 and paragraph 12A will not be applicable to the extent that the face value of the debt and the subscription loan are of the same value, the applicants may still be subject to a challenge based on the market value of the shares issued in terms of section 24BA. This aspect requires further investigation, which is done in this chapter.

In both the rulings issued, debts were set off between the debtor and creditor in their respective capacities and no other parties were involved. The debts were of the same nature (both monetary debts) and liquidated. The first transaction step in BPR 193 was for the creditor to demand repayment of the debt, presumably in order to make the debt due and payable. A further requirement in this ruling was that the subscription loan had to become unconditional before set-off could take place. Although the rulings did not specifically indicate this, the characteristics of the debt in these rulings, as well as the conditions imposed by the SARS, all seemingly relate to the legal requirements for set-off. In order to establish if this is indeed the case, the legal requirements for set-off requires further investigation, which is subsequently done.

3.3 The requirements for set-off

The requirements for set-off are settled and uncontentious (van Deventer, 2016:35). The requirements that have emerged from the common law and case law over time for set-off to operate are summarised in Wille's Principles of South African Law (Hutchison & Du Bois, 2007:832).

Firstly, both debts must be of the same nature. This requires that the debts must be of the same kind (Van Deventer, 2016:37). In the context of debt capitalisation, this condition should not be difficult to overcome, as both the pre-existing debt as well as the subscription loan are monetary debts. Van Deventer (2016:37) states that it is, however, uncertain whether debts will still be of the same kind when different currencies are involved and that this topic has not often been considered in South Africa. In this regard, the question arises if realised and unrealised foreign exchange gains and losses on debts denominated in foreign currencies are capable of being set off, as will be the case for foreign inbound loans for South African debtor companies. In the hands of the debtor, the debt and subscription loan comprise the original capital amount as well as a component of foreign exchange differences, whereas in the hands of the creditor, the debt is only the original capital component. According to Fountoulakis (2010:105), debts expressed in different currencies are eligible for purposes of statutory set-off. The principle was also confirmed in the English case of *Gary Fearns v Anglo-Dutch Paint & Ors (2010) EWHC 2366 (Ch).* The court found that the respective debts which were to be set off should be converted into a common currency on the date of the judgement, as this was the date on which the existence and amount of the two liabilities were established. The common currency into which the debts must be converted should be determined by the respective values of the debts. The smaller amount should be converted into the currency of the larger amount at the exchange rate prevailing on the date of the conversion (Allen and Overy LLP, 2010:1).

If the principles established in the *Gary Fearns v Anglo-Dutch Paint & Ors* case are made applicable to debt capitalisation when foreign denominated debts are capitalised, there are a number of considerations. In the judgement, the date on which the conversion took place was established to be the date on which the existence and amount of the two liabilities was established. During capitalisation this is the date on which the creditor subscribes for shares in the debtor and when the subscription loan is established. Furthermore, a foreign exchange gain or loss will arise on thedate of set-off as each exchange item would realise as contemplated in section 24I. If the exchange differences result in a gain, this gain will be taxable in terms of section 24I(3)(*a*) (SARS, 2017a:131). In a case where a debt reduction occurs no exchange losses will be recouped in terms of section 19(5), as the losses are not ‘expenditure’ incurred as contemplated in section 19(2) (SARS, 2017a:131). However, any exchange losses, whether they previously resulted on conversion of the debt into local currency or arise as a result of set-off, will be recouped in terms of section 8(4)(*a*).

For set-off to operate, the second requirement is that both debts must be liquidated, which according to Van Deventer (2016:40) means that the person relying on set-off must be able to prove the claim easily. With reference to a plaintiff’s claim, Coetzee J indicates in *Quality Machine Builder v M I Thermocouples (Pty) Ltd (1982) (4) SA 591 (W)* that a claim was liquidated because the price on which it was based was easily and speedily ascertainable. A liquidated claim therefore refers to a claim of which the existence can be ascertained without challenge in a timely manner. In *Standard Bank of South Africa Ltd v Renico Construction (Pty) Ltd (2015) (2) SA 89 (GJ),* Sutherland J indicates that detecting the condition of liquidity is a topic of some agitation. Although not in alignment with the established principles, the judge accepts prior judicial precedent and concludes that the concept of ‘liquidity’ has a form of judicial discretion and should be decided on the particular facts. In the context of debt capitalisation, it is unlikely that both the pre-existing debt and the subscription loan will not be liquidated debts. Entering into the capitalisation transaction should be indicative of the fact that the debtor acknowledges its indebtedness towards the creditor and wishes to convert this debt into equity. The existence and quantum of the pre-existing debt has already been established and there is cooperation between the debtor and creditor to expunge this debt by entering into the arrangement. The issue of the shares on loan account should also be sufficient to substantiate the liquidity of the subscription loan due to the debtor. The requirement for debts to be liquidated will therefore be met when capitalisation takes place through set-off.

A further requirement for set-off is that both debts must be fully due and payable. This, according to Van Deventer (2016:38), means that debts should be enforceable and where a claim is even temporarily unenforced, set-off cannot take place. This is also the case where debts are subject to time clauses or contain suspensive conditions (Van Deventer, 2016:38). A relevant consideration in this regard is where the pre-existing debt is time bound, for example, a long-term loan that is only repayable at a date in the future, which the parties wish to capitalise at an earlier date than when the debt matures. Another possibility is that the subscription loan is made subject to a time clause and is only due at a point in future. Where debtors and creditors use set-off as a cause for action or rely on set-off as a defence, such a time clause could be a preclusion for set-off to operate. However, where the parties enter into the capitalisation arrangement and wish to convert the debt into equity, even though debts are only due in the future, they should through agreement, be able to conclude set-off at an earlier time. On the same basis that a contractual liability arises where there is a meeting of the minds and *quasi-mutual* assent (*K2012150042 (South Africa) (Pty) Ltd v Zitonix (Pty) Ltd (2017) 2 All SA 232 (WCC)*), the parties can change the payment terms of debts and, as such, this requirement is met in the context of debt capitalisation.

The last requirement for set-off to be possible is that debts must be payable by the debtor and the creditor in the same capacity and not to (or by) a third party. Van Deventer (2016:35) indicates that a debtor cannot set off a debt owed to a creditor against a debt that the creditor owes to another third party, even where the necessary consent has been obtained from the third party. In the context of debt capitalisation, this would mean that the subscription loan has to be set off against the pre-existing debt. Before the pre-existing debt and the subscription loans are set off, regard must, however, be given to the nature of the pre-existing loan as an asset in the hands of the creditor. If the creditor has ceded the debt, the debt will not be suitable for set-off as the cessionary succeeds the creditor (Van Deventer, 2016:36). When a debt has been ceded, the debtor and the creditor no longer owe the respective debts to each other in the same capacity, and the subscription loan cannot be set off against the pre-existing debt. However, in the absence of any encumbrances on the debt, there is nothing that prohibits set-off for capitalisation to occur.

The legal requirements for set-off that have been established can be aligned with debt capitalisation through set-off. Although there are indeed some aspects to consider before the pre-existing debt and the subscription loan are made subject to set-off, debt capitalisation does not have any special characteristics or anomalies that cannot be implemented by using well-established principles. While debt capitalisation through set-off meets legal requirements, considering whether it may still result in a 'reduction amount' is also necessary. Accordingly, the terms 'amount applied' and 'consideration' should be considered in more detail in the context of set-off in the sections which follows.

3.4 The terms 'amount applied' and 'consideration'

During the analysis of the term 'reduction amount' in Chapter 2, the finding was made that in order for an amount to be applied as 'consideration', a debt must be validly discharged. As opposed to considering whether the issue of shares validly discharges an obligation, as was necessary in Chapter 2, establishing whether set-off validly discharges an obligation is necessary in this instance. The SARS (2016c:15) quotes Hutchison and Du Bois (2007:831) and states that set-off results in the:

> *extinction* pro tanto *of debts owed reciprocally to each other by two persons … Set-off is equivalent to payment and it consequently operates* ipso facto *and* ipso jure*, automatically, as a* **discharge** *total or partial, of the debts in question, the moment four conditions or sets of facts occur.*
> *[own emphasis]*

Van Deventer (2016:1) indicates that set-off extinguishes obligations as effectively as if they would have been discharged by performance. In *Siltek Holdings (Pty) Ltd (in liquidation) t/a Workgroup v Business Connexion Solutions (Pty) Ltd*, the Supreme Court of Appeal finds that in essence, set-off constitutes a form of payment by one party to the other. There is little doubt that set-off is a well-established principle and that it indeed legally discharges obligations, provided that the requirements thereof are met.

In terms of set-off, it is not necessary to consider the requirement for cash flow, as the very nature of set-off is that neither party requires performance (Van Deventer, 2016:1). Section 38 of the Companies Act 61 of 1973 ('the 1973 Companies Act'), determined that no company was allowed to provide any financial assistance for the purchase of shares in the company. This prohibition applied to loans, guarantees and the provision of security or otherwise. The section 38 of the 1973 Companies Act provision would therefore have prohibited the set-off structure currently employed by taxpayers, since no obligation could have been created that could be set off against the pre-existing debt. Unless, on a different technical exception to the section 38 of the 1973 Companies Act prohibition, cash flow would have been required for the share subscription. The Companies Act requires, in terms of section 40, that a company receives ‘adequate consideration’ in order to issue shares. Furthermore, in terms of section 44(2) of the Companies Act, the board may authorise the company to provide financial assistance by way of a loan to any person for the purpose of, or in connection with, the subscription of securities. Therefore, cash is not specifically required. The definition of ‘consideration’ in terms of the Companies Act analysed in Chapter 2, allows for a company to issue shares on loan account without cash, which provides for the structure required to execute debt capitalisation through set-off. When considering the value of the ‘amount applied’ in set-off, substantially the same matters have to be addressed as was done in Chapter 2 with debt capitalisation through direct settlement. The concepts ‘market value’ of shares issued, the ‘subscription price’ for those shares (in this case represented by the subscription loan) and the ‘face value’ of debt remain relevant in the case of set-off and the same meanings are attached to those concepts. A pertinent difference, however, arises between direct settlement and set-off regarding the value of the amount applied, due to the application of section 24BA.

3.4.1 Difference between market value of shares and the face value of debt

A ‘reduction amount’ will not arise to the extent that an amount has been applied as ‘consideration’ for the reduction of that debt. With set-off, the amount applied as ‘consideration’ and with which the debt is reduced, is the value of the subscription loan. When the subscription loan is sufficient to reduce the face value of the pre-existing debt, set-off will not give rise to a ‘reduction amount’ for purposes of section 19 and paragraph 12A (SARS, 2016c:11). In turn, this will mean that if the subscription loan is less than the face value of the debt against which it is set off, this will result in debt reduction. The mere fact, however, that set-off of the subscription loan against the pre-existing debt does not result in a ‘reduction amount’ if at least the face value of the debt has been applied as ‘consideration’, does not mean that adverse tax consequences could not result from the set-off.

The mischief addressed by section 24BA is value-shifting (Lewis, 2014:1). The section is applicable in very specific circumstances when an asset, as defined in paragraph 1, is acquired by a creditor in exchange for the issue of shares by the debtor company.

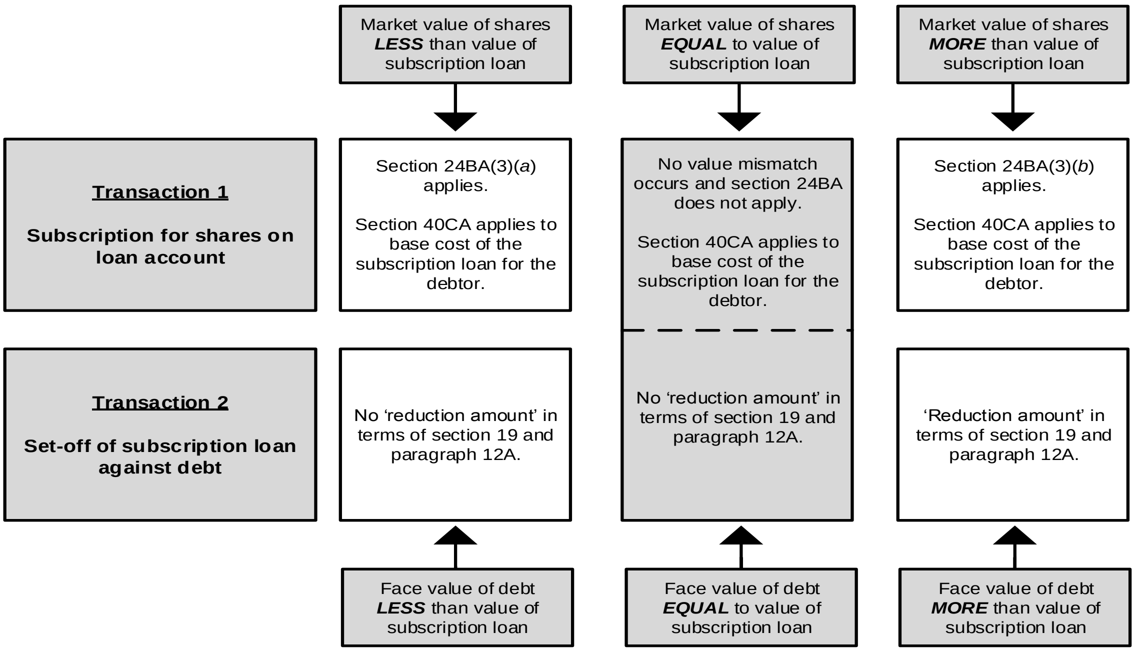
Although the section is mainly focused on asset-for-share transactions in terms of section 42 (Lewis, 2014:1), the section does not exclude any other transactions and should be considered in the case of set-off, unless one of the exclusions in section 24BA(4) applies. As indicated in Chapter 2, the main terms in the definition of 'asset' in paragraph 1 are 'property' and 'a right'. The SARS (2015d:39) describes 'property' as "anything that can be disposed of and turned into money". 'A right' includes both personal rights and real rights that can be enforced against a particular person or group of persons (SARS, 2015d:43). When a creditor subscribes for shares on loan account, the debtor company acquires an 'asset' in the form of an enforceable right against the creditor company to claim payment of the subscription price, in exchange for the issue of the shares. Therefore, section 24BA is relevant in the case of set-off when creditors subscribe for shares on loan account (the subscription loan that will eventually be set off against the pre-existing debt).

In determining the potential application of section 24BA, the value at which the subscription loan is issued in exchange for shares in the debtor is a relevant consideration. Section 40 of the Companies Act determines that a company must receive 'adequate' consideration when shares are issued. The SARS (2016c:11) indicates that 'adequate' consideration does not mean that the subscription price will be equal to the market value. This view is shared by Brincker (2011b:1), who indicates that even shares issued at a discount could amount to 'adequate' consideration in terms of the Companies Act. Since the Companies Act does not require consideration to be market-related, debtors can issue shares at a premium or discount to the market value thereof. When shares are indeed issued at market value, there is no mismatch in the values received and value forborne by the debtor and creditor respectively. There is accordingly no value shifting and section 24BA will not be relevant. However, when shares are issued at a discount, or a premium, section 24BA will impose tax consequences on the debtor and creditor.

In terms of section 24BA(3)(*a*)(i), a capital gain will result for the debtor company if, immediately after the issue of the shares, those shares have a market value which is less than the subscription loan (this is notwithstanding the fact that the issue of shares is not a disposal in terms of paragraph 11(2)(*b*)). The debtor company could potentially also suffer a second capital gain when set-off occurs. When the subscription loan is set off against the pre-existing debt, the extinction of the subscription loan will result in a disposal of the asset in terms of paragraph 11. Section 40CA, which applies if section 42 does not apply to a transaction, deems the base cost of the subscription loan that is disposed of to be equal to the market value of the shares issued. The debtor company will therefore dispose of an asset (the subscription loan) of which the base cost is lower than the proceeds (face value) of the debt discharged (paragraph 35(1)(*a*)). The creditor who receives the shares must reduce its cost actually incurred for those shares with the excess by which the face value of the debt exceeds the market value of the shares. Where the creditor holds the shares as capital assets, the base cost should be reduced, and where the shares are held as trading stock, the amount taken into account in respect of those shares in terms of section 11(*a*) or 22(1) or 22(2)) should be reduced (section 24BA(3)(*a*)(ii)).

In the event that the market value of the shares exceed the face value of the subscription loan, the excess will be deemed to be a dividend *in specie* paid by the debtor company (section 24BA(3)(b)). Section 40CA in this case gives the benefit of a step-up in base cost for the subscription loan which will result in a capital loss when set-off takes place (due to the base cost being higher than the face value of the debt). However, this benefit is offset by the debtor having been deemed to distribute an asset *in specie* (SARS, 2015d:334), but only to the extent that no exemption or reduction in the rate of tax applicable to dividends *in specie* in terms of section 64FA applies. Section 24BA does not regulate the base cost of the shares acquired by the creditor where the market value of the shares issued is higher than the face value of the debt (SARS, 2015d:334), and under normal principles, the creditor will be deemed to acquire the shares at the lower face value of the debt. **Figure 3.2** illustrates and summarises the interaction between sections of the Act and transaction values for the two-step transaction approach of set-off.

Figure 3.2: Interaction between sections of the Act and transaction values



There are a number of exclusions to the application of section 24BA. If, immediately after the acquisition of the asset (which will be at the same time as the issue of the shares and accompanying establishment of the subscription loan), the debtor company forms part of the same 'group of companies' as defined in section 1, or the creditor holds all the shares in the debtor, the tax consequences of the value-shifting arrangement are not applicable. Section 24BA will also not find application if paragraph 38 of the Eighth Schedule, dealing with disposals of assets between connected persons not at arm's length, is applicable.

From the analysis above, section 24BA is submitted as an important consideration when debt capitalisation is performed through set-off. If established that none of the exclusions to the section are relevant, both the debtor and creditor should consider the tax consequences of section 24BA, as both shares issued at a premium or discount to the value of the subscription loan has tax consequences. Having considered the legal requirements for set-off as well as the consequences of differences between the value of the subscription loan and the face value of the debt, the second research question can be concluded on in the overall conclusion to this chapter.

3.5 Overall conclusion

This chapter considered whether debt capitalisation through set-off could result in a 'reduction amount' in respect of which section 19 and paragraph 12A are applicable. Debt capitalisation through set-off requires at least two obligations that can be set off. The method that is used to establish the second obligation (in addition to the pre-existing debt that is capitalised) is through the creditor subscribing for shares in the debtor on loan account. This is an appropriate method of 'consideration' in terms of the Companies Act. The four legal requirements for set-off to operate can be met when executing debt capitalisation through set-off. Although there are a number of practical considerations in this regard, including the currencies in which the debts are denominated and whether the debts are due and payable, the legal requirements do not place an absolute restriction on debt capitalisation through set-off.

In evaluating 'reduction amount' a finding was made that set-off extinguishes the reciprocal debts between the debtor and the creditor. Set-off therefore constitutes an 'amount applied' towards the reduction of the debtor's obligation toward the creditor. In Chapter 2, the second question into the analysis of the term 'reduction amount' was whether the waiver or forbearance of a right to claim payment by the creditor in exchange for the issue of shares by the debtor company amounts to 'consideration'. In answering this question, an analysis of the ordinary meaning of 'consideration', its meaning in terms of case law as well as its meaning in terms of the Companies Act was performed. A finding was made that 'consideration' allows for an interpretation of something forborne in exchange for something else, including the forbearance of a right. It is submitted that this finding and the basis on which the finding was made, is also applicable in the case of set-off. When set-off takes place and the reciprocal debts are extinguished, the right to claim payment from the creditor for the subscription loan, which is forborne, constitutes consideration for the debt. Given that set-off therefore constitutes an 'amount applied' as 'consideration', executing debt capitalisation through set-off does not lead to a 'reduction amount' in respect of which section 19 and paragraph 12A is applicable, to the extent that the subscription loan exceeds the face value of the debt.

Evaluation of the market value of shares issued when establishing the subscription loan remains a valid consideration. Section 24BA has a very specific field of application, which will be applicable when debts are capitalised through set-off. This section prohibits any value mismatches or value-shifting between the debtor and the creditor when the subscription loan is advanced on loan account. Section 24BA may result in capital gains tax consequences or dividends tax consequences for the debtor, if there is a difference in the market value of the shares issued, relative to the face value of the debt. This matter is not specifically addressed in any of the BPRs issued by the SARS on debt reduction through set-off.

Thus far, the study has shown that both direct issue of shares and debt capitalisation through set-off constitutes an ‘amount applied’ as ‘consideration’. In Chapter 4, the final method of debt capitalisation, namely the conversion of debt instruments, is considered in more detail.

CHAPTER 4
CONVERSION OF DEBT INSTRUMENTS

4.1 Introduction

Companies finance their assets and operations through a combination of debt and equity (Van der Linde, 2011:2). Part D of the Companies Act regulates the capitalisation of profit companies and makes provision for different types of funding instruments, including debt and securities. In terms of section 43(1)(*a*) of the Companies Act, a 'debt instrument' includes securities other than the shares of a company. Section 1 of the Companies Act defines 'securities' as any shares, debentures or other instruments issued by a company. 'Convertible securities' are in turn defined in section 1 of the Companies Act as any securities of a company that may be converted into other securities based on the terms that attach to those securities. Through these definitions, the Companies Act clearly makes provision for the conversion of debt instruments into shares of a company. Such convertible instruments may take the form of, among others:

- Convertible bonds (Royal Bafokeng Platinum Ltd, 2017:1);
- Convertible debentures (SARS, 2017b:7); and
- Contingent convertible capital instruments (Liebenberg, et al., 2016:369).

In the context of hybrid debt instruments, National Treasury (2013:29) indicates that a key feature of debt is the ability by the holder of the debt to redeem the capital within a reasonable time. If debt does not have this feature, it operates more like equity. The period for capital redemption or conversion of convertible debt instruments is regulated through agreement and the terms of discharging the obligation are fixed before the debt instrument is issued. In relation to a 'debt instrument', the Companies Act defines a 'security document' as a document that embodies the terms and conditions of the debt instrument. For example, in the case of debentures, redemption or conversion is regulated by an indenture document (Johannesburg Stock Exchange, 2017b:3) and bonds are regulated by a convertible bond listing.

The discharge of a debtor's obligation in terms of a debt instrument can be achieved either through the conversion of the debt instrument into shares or through the redemption thereof in cash. For example, convertible bonds can be converted into shares at the election of the bond issuer, the bondholder, or both (Wormald, 2013:11). Furthermore, bonds can be redeemed in cash at the option of the issuer or the bondholder (Wormald, 2013:11-12). In this instance, the possibility exists that the creditor can use the cash proceeds from the redemption to subscribe for shares in the debtor, which will in essence be the same as debt capitalisation through direct settlement. The Act recognises the two methods of discharging obligations attached to debt instruments, being redemption and conversion. Section 8F(1) defines 'redeem' as the discharge of all liability to pay an amount in terms of the instrument and also acknowledges that taxpayers could 'convert' or 'exchange' debt instruments into shares. Section 24J contains a similar definition for 'redemption' of an instrument, being the discharge of all liability to pay an amount in terms of the instrument. The SARS (2015d:77) indicates that 'conversion' involves a substantive change in the rights attached to assets. The distinction between conversion and redemption as well as the effect in the financial statements of the debtor company is illustrated by the journal entries in **Table 4.1**.

Table 4.1:
Transaction steps for conversion compared to a redemption in cash

Conversion at the election of the issuer or the holder of the debt instrument	**Redemption in cash at the election of the issuer or the holder of the debt instrument**
Journal entry in records of debtor: Dr Debt instrument Cr Share capital	**Journal entry in records of debtor:** Dr Debt instrument Cr Cash **Optional subscription for shares:** Dr Cash Cr Share capital

Author compiled

In the case of redemption in cash, no shares are issued in exchange for the release from the obligation and, accordingly, no debt capitalisation takes place (unless the creditor uses the cash proceeds and subsequently subscribes for shares in the debtor at their own discretion). Debt capitalisation by means of conversion is only applicable if the debt instrument is converted into equity in terms of the conversion rights stipulated in the security document. A distinction is therefore drawn between a redemption in cash and subsequent optional subscription for shares and the conversion of a debt instrument into shares in line with the terms of the security document. In this chapter, it will be considered if either of these situations may result in a ‘reduction amount’, also taking into consideration the value of the shares during conversion. The BPR that has been issued by the SARS dealing with the conversion of debt instruments will also be analysed.

4.2 Binding Private Ruling: Conversion of debt instruments

In line with the approach followed in Chapter 2 and Chapter 3 to consider BPRs issued by the SARS on a specific method of capitalisation, an evaluation of BPR 246 issued on capitalisation of debt instruments to shares is necessary. This is done in order to establish whether there are specific reasons for the SARS ruling on whether or not capitalisation of debt instruments to shares results in a ‘reduction amount’. **Table 4.2** summarises the BPR 246.

In BPR 246, the creditor is an *en commandite* partnership that holds 64,69% of the ordinary shares in the debtor (a resident company). This shareholding structure does not constitute a ‘group of companies’ as defined in section 1, as neither the 70% holding of shares requirement, nor the requirement for two or more companies are met. The debtor and creditor in BRP 246 would therefore not benefit from any relief in terms of the Draft debt reduction provisions if enacted in its current form, since draft section 19(8)(*e*) requires a group of companies for debt capitalisation to not constitute a ‘reduction amount’. The uncertainty of whether the conversion of debt instruments results in a ‘reduction amount’ would therefore remain relevant in a set of facts similar to BPR 246. Interest on the debentures, which are capitalised as part of the redemption of the debentures in the ruling, will furthermore be subject to recoupment in terms of the proposed section 19B.

The factual background in BPR 246 provides no indication whether the security document allowed that the debentures may be redeemed in cash, or any conversion rights associated with the debentures. Given the method of capitalisation employed by the debtor and creditor, being redemption in cash and subsequent subscription for shares, BPR 246 is argued as similar to debt capitalisation through the direct issue of shares and as such would constitute an ‘amount applied’ as ‘consideration’ as concluded in Chapter 2.

The ruling indicates that section 19 and paragraph 12A will not be applicable to the transaction; however, there are matters relating to convertible debt instruments that the ruling does not address since there is limited information on the stipulations of the security document. Particularly, the relevant question of the market value of the shares issued is not specifically addressed. BPR 246 therefore offers limited guidance on the question of whether or not the conversion of debt instruments into shares result in a ‘reduction amount’. Accordingly, a more detailed investigation into the term ‘amount applied’ and the market value of the shares issued is required, which is subsequently done.

Table 4.2: Summary of the Binding Private Ruling dealing with conversion of debt instruments to equity

BPR	**Debtor**	**Creditor**	**Transaction**	**Specific ruling on debt reduction**
246 (24 August 2016)	A company incorporated in and a **resident** of South Africa.	*En commandite* partnership formed in and a **resident** of South Africa which holds 64,69% in the debtor party to the debt capitalisation.	The debtor will redeem debentures previously issued at **full value**, including all accrued but unpaid interest. The redemption will be financed through a bridge financing arrangement. The creditor will subscribe for **preference shares** in the debtor, using the proceeds from the redemption of the debentures.	The redemption of the debentures at **full value** will not be subject to the provisions of section 19 or paragraph 12A of the Eighth Schedule.

Author compiled from the following source:

SARS, 2016a

4.3 The term 'amount applied'

Although there can be distinguished between the conversion of debt instruments into shares or the redemption of the debt instruments to cash and subsequent subscription for shares (**Table 4.1**), it is submitted that both instances will result in an 'amount applied'.

In the case of redemption for cash and subsequent subscription for shares the method is submitted as similar to debt capitalisation through direct settlement, as was the case in BPR 246. When dealing with the conversion of debt instruments to equity, the SARS (2016c:9) indicates that the conversion is done in fulfilment of the rights attached to the debt instrument at the time of issue thereof. When conversion takes place outside of the security document, the discharge of the obligation is not in terms of rights and obligations attached to an instrument at the time of the issue of the instrument, as is the case with direct settlement. In Chapter 2 it has already been shown that the issue of shares does indeed discharge an obligation in terms of a debt. Conversion of a debt instrument into shares outside the terms of the security document therefore constitutes an 'amount applied' as 'consideration'.

In the case of conversion in terms of the provisions of the security document, the release of the obligation is contractually regulated. Both the debtor and the creditor agree to the terms of the release upon the debtor issuing the debt instrument. Discharge of the obligation to pay the debt is therefore an inherent part of the debt instrument when the instrument is issued. Section 40(1)(*b*) of the Companies Act furthermore indicates that the board of a company may issue shares in terms of the conversion rights associated with securities (that include debt instruments) that have been issued. As such, when conversion takes place in terms of the provisions of a security document, there can be no question that the obligation is discharged for an 'amount applied'.

The ratios and values for the conversion of debt instruments into shares are often fixed at the issue date thereof. For example, in its 2006 bond offering, Network Healthcare Holdings Ltd (2006:1) fixed an initial conversion price for bonds that were convertible in 2011. Given that the values of conversion may be fixed in advance, a change in the value of the 'amount applied' could result in tax consequences upon the conversion of debt instruments into shares. As it has been shown in Chapter 2, a comparison between the concepts 'market value' of shares issued and the 'face value' of debt are relevant in this context, which will now be investigated under section 4.3.1 to follow.

4.3.1 Difference between market value of shares and the face value of debt

The market value of shares issued when debts are converted into shares is a relevant consideration. Section 8F, for example, determines that an instrument will not be a 'hybrid debt instrument' if the market value of shares issued on conversion is equal to the amount owed in terms of the debt instrument at the time of conversion. the SARS (2016c:11-12) indicates that when debt instruments are converted into shares, the market value of those shares must be determined, since the consideration for the reduction of the obligation to pay is in a form other than money. If the market value of the shares issued on conversion is less than the face value of the debt instrument (generally the redemption amount), a 'reduction amount' will arise as result of the amount of the 'consideration', being the market value of the shares that is less than the value of the debt (SARS, 2016c:12). This is a particularly relevant consideration for the issuers of convertible securities, as initial conversion ratios and prices are often quoted in security documents upon issue of the debt instruments. If no provision is made for the potential adjustment of conversion prices to bring the prices in line with the market value of shares issued upon conversion, this will lead to a 'reduction amount' in respect of which the debt reduction regime applies. The market value of shares on conversion of debt instruments must also be considered in terms of other sections of the Act and the interaction of those sections with the debt reduction regime.

Section 25BB(8) is deemed to have come into operation on 1 April 2013 with the introduction of the REIT regime. The section determines that if a REIT cancels the debenture part of a linked unit and capitalises the issue price of the debenture to stated capital, the cancellation of the debenture must be disregarded in determining the taxable income of the REIT (section 25BB(8)(*a*)). Kantilal (2016:40) indicates that this relief is in respect of the provisions of the Act relating to the reduction of debt. Since it has been shown that the issue of shares do indeed constitute an 'amount applied' by discharging debt obligations, the reason for the Legislature's specific inclusion of this relief in the REIT regime is arguably to accommodate the market value of the shares issued. Section 25BB(8) specifically deals with the capitalisation of the ***issue price*** of the debenture to the stated capital of the debtor. The section does not deal with with, or require that, the capitalisation occurs at market value. If not for the specific relief in section 25BB(8), a reduction amount would have resulted if the market value of the shares issued on capitalisation was less than the issue price of the debenture.

A further necessity for the inclusion of section 25BB(8) is arguably due to the provisions of section 24J. Section 24J is not applicable when holders of a debt instrument have the right to require the redemption of the debt instrument or the debt instrument does not provide for the payment of deferred interest (section 24J(12)). If a debt instrument is indeed within the ambit of application of section 24J, an adjusted gain or loss on redemption will accrue to the creditor (section 24J(4)). Camay (2014:1) suggests that 'redemption' also includes the conversion of debt instruments into shares. Accordingly, the conversion of debt instruments into shares can result in an adjusted gain or loss on conversion for the creditor, in terms of section 24J(4)(*a*), if the creditor holds the debt instrument on revenue account or a capital gain or loss if the debt instrument is capital in nature (South African Institute of Chartered Accountants, 2015:2-3). This finding corresponds to the SARS (2015d:79) comments that a capital gain or loss should be determined in respect of a convertible debenture at the time of conversion. To the extent that any 'reduction amount' would have resulted due to a mismatch between the market value of the shares issued on conversion and the face value of the debt instrument (the issue price thereof) and included in taxable income in terms of section 19, section 24J(4) will not be applicable (24J(4A)(*b*)).

Had it not been for the relief granted in terms of section 25BB(8), the change in the capital structure of REITs could have resulted in either revenue or capital gains or losses for the holders of the linked units.

In Chapter 2 the very specific circumstances, in which the value-shifting provisions of section 24BA are applicable, were discussed in the context of the market value of shares acquired during debt capitalisation. A finding was made that on a strict interpretation of the phrases 'property' and 'a right' as part of the definition of 'asset' in the Eighth Schedule to the Act, a release from an obligation to pay would not resort under the definition of an 'asset'. This is because the debtor does not acquire an enforceable right against the creditor but is rather released from an obligation to perform. This finding remains relevant in the case of debt instruments when converted into shares. Since conversion takes place in terms of a security document and there are no other transaction steps during conversion in which the debtor acquires an 'asset', section 24BA would not be applicable. Any potential value-shifting would then be addressed by sections 19, section 24J and the provisions of the Eighth Schedule.

From the analysis of the market value of the amount applied as well as section 24J, a conclusion can be made that it was necessary for the Legislature to provide for specific relief in section 25BB(8) when the capital structures of REITs are changed from a linked-unit structure to a capital-only structure. However, the relief is only applicable to the REIT regime. When conversion of debt instruments into shares is done outside of these provisions, a mismatch between the face value of the debt instrument and the market value of the shares issued could lead to a 'reduction amount' in terms of section 19, or an adjusted gain or loss in terms of section 24J.

4.4 Overall conclusion

In this chapter it was considered whether the conversion of debt instruments into shares results in a 'reduction amount' in terms of which the debt reduction regime applies. Limited guidance can be obtained from BPR 246 that has been issued by the SARS dealing with the capitalisation of a debt instrument and, as such, an investigation into the term 'amount applied' as well as the market value thereof was performed. A conclusion was reached that since the conversion of debt instruments into shares is regulated through agreement in a security document, as well as the fact that the issue of shares validly discharges a debt, the conversion of debt instruments into shares constitutes an 'amount applied'. The requirement for cash flow will be determined by the terms of the debt instrument. For example, Wormald (2013:11-12) indicates that bonds can generally be redeemed at either the option of the issuer or at the option of the holder. When redemption for cash takes place, naturally cash is required (although this does not constitute debt capitalisation). Conversely, when the debt is converted into shares, the terms of the debt instrument is that no cash is required.

Regarding a difference in the market value of shares issued when conversion takes place and the face value of debt, a finding was made that a 'reduction amount' will arise if the market value of shares are less than the face value of the debt instrument.

This is for the same reason that a ‘reduction amount’ arises with debt capitalisation through direct settlement when the market value of the shares issued are less than the face value of the debt. This argument is based on Visser’s (2014:1) conclusion that when debts are capitalised the conversion of the debt into shares results in a dilution of the creditor’s rights, due to a lower value attributable to the shares than to the face value of the debt and the resulting mismatch in value. Furthermore, to the extent that the full value of the mismatch is not included in the taxable income of the debtor in terms of section 19, section 24J(4) may result in an adjusted gain or loss that accrues to the debtor on conversion. For these reasons, it was necessary for the Legislature to include specific relief for REITs in terms of section 25BB(8) when converting their capital structures.

With reference to the ordinary meaning of ‘consideration’ and the meaning in terms of case law, it has already been shown in Chapter 2 that the waiver or forbearance of a right to claim payment by the creditor in exchange for the issue of shares by the debtor company amounts to ‘consideration’. This finding remains relevant in the case of the conversion of debt instruments into shares, particularly since the conversion of debt into shares is regulated by a contractual arrangement, namely the security document. In this regard, the comments from both Hyprop Investments Ltd (2014:1) and Orion Real Estate Ltd (2015:1), in their respective circulars to holders of shares, dealing with the change in the capital structure appears to be in contrast to a technical interpretation of ‘consideration’. In the circulars, the REITs indicate that the conversion of their linked-unit structure into a capital-only structure involves “the proposed cancellation of each debenture, for no consideration”. An integral part of the conversion into the capital-only structure, is the capitalisation of the issue price of the debenture. Given that linked-unit holders receive shares when the debenture is cancelled, they do indeed receive ‘consideration’. It is, however, submitted that this is not a material consideration due to section 25BB(8) that provides relief from any amounts to be included in the taxable income of the REIT on conversion.

Having considered all three methods of debt capitalisation, a conclusion can now be reached in Chapter 6 on the primary research questions posed in Chapter 1. Chapter 5 addresses other areas of uncertainty relating to debt capitalisation not specifically addressed as part of the primary research questions.

CHAPTER 5
OTHER TAX AREAS OF UNCERTAINTY

5.1 Introduction

As a secondary objective of this study, a number of areas of uncertainty in the law of taxation in respect of debt capitalisation not dealt with as part of the primary research questions are highlighted in this chapter. The uncertainties have been identified through the literature considered in concluding on the primary research questions of the study. The purpose of including these uncertainties is neither to compile an exhaustive list, nor to conclude specifically on other tax considerations relating to debt capitalisation. However, consideration of the following items is necessary, given the interaction between current tax legislation, proposed legislative amendments and tax policy matters on transactions concluded by taxpayers:

- Draft debt reduction provisions;
- General anti-avoidance rules;
- Base erosion; and
- Reportability.

These selected areas of uncertainty deal directly with debt capitalisation as well as policy-related matters that are applicable to all arrangements concluded by taxpayers. Although there may be additional tax matters in debt capitalisation that warrant consideration, the selected themes discussed in this chapter have recently been topical, both locally and internationally. Locally, this is evident from the SARS's reference to the GAAR in the two most recent BPRs issued (BPR 246 and BPR 255) and National Treasury's concerns regarding the fiscal risks of cross-border interest payments in debt waivers (South African Institute of Chartered Accountants, 2017:2). Internationally, an extensive public consultation process on debt capitalisation was held in New Zealand (NZIR Policy and Strategy, 2015a:1) to determine the tax consequences thereof. The relevance of the New Zealand consultation process to the South African debt reduction regime is also subsequently discussed in this chapter.

5.2 Draft debt reduction provisions

The Draft debt reduction provisions issued by National Treasury during July 2017 make a number of proposals to the tax consequences of debt capitalisation. In addition to the proposed section 19A, in terms of which interest previously allowed as a deduction will be recouped when capitalised, amendments to the exclusions from application of section 19 and a new section 19B are proposed. These proposed amendments are summarised in **Table 5.1**, followed by a number of uncertainties emanating from the Draft debt reduction provisions.

Table 5.1: Summary of the Draft debt reduction provisions

	Section 19(8)(*e*)	**Section 19B**
Targeted relief	Based on the characteristics of the debt.	Based on the characteristics of the debtor-creditor relationship.
Method of capitalisation	Directly or indirectly	Directly or indirectly
Type of debt	Only intra-group debt, external debt excluded.	Only intra-group debt, external debt excluded.
Effect if applicable	Debt capitalisation does not result in a 'reduction amount'.	Recoupment of the difference between the face value of debt capitalised and the market value of shares on the date that the debtor and creditor de-group.
Timing	Immediate relief from debt reduction in the year of assessment during which debt capitalisation takes place.	Imposes restrictions on de-grouping for five years after debt capitalisation (otherwise amounts are recouped).
Requirements	Debt has to meet certain requirements, including that it needs to originate from within the group of companies.	Conversion or exchange of debt into shares and amount must be applied within the group.
Effect of capitalisation on the debt	Debt must be reduced *or* settled.	Debt must be settled.
Market value of shares	Not addressed in the proposed section.	Only relevant if de-grouping takes place.

Author compiled from National Treasury (2017b)

In the Draft debt reduction provisions, there is currently no indication of the effective date of section 19A that deals with the recoupment of capitalised interest. A reasonable assumption is that it will be effective form 1 January 2018, in line with the amendments to section 19 and the introduction of section 19B. Furthermore, there is no indication that the draft sections 19A and 19B will only be applicable to debt capitalisation transactions that will occur after the effective date. Whether interest capitalised before the assumed effective date will be subject to any recoupments or the de-grouping restrictions will apply to transactions already concluded on the effective date, remain unsure. Although there is a general presumption that legislation will apply only prospectively, there is evidence that new tax legislation applies in respect of transactions already concluded at the effective date of new legislation. This was, for example, the case with section 7C, which includes in its scope of application amounts owed by a trust in respect of a loan already in existence on its effective date of 1 March 2017. It is therefore likely that the Draft debt reduction provisions could affect debt capitalisation transactions already concluded prior to the effective date, including those that were the subject of BPRs issued by the SARS.

Draft section 19(8)(*e*) refers to debt that should be reduced *or* settled, while draft section 19B refers only to debt that should be settled and does not refer to the reduction of debt. It is not clear if the Legislature purposefully includes the reduction of debt only in respect of section 19(8)(*e*) or if it can be assumed that the settlement of debt in section 19B should include a reduction, or partial settlement as well. The application of section 24BA was extensively discussed in this study, in respect of all three methods of debt capitalisation. However, the Draft debt reduction provisions do not include any reference to the interaction with section 24BA. In the lack of specific guidance from the proposed legislative amendments, it is submitted that the conclusions reached in this study on the application of section 24BA to debt capitalisation, remain relevant, despite the Draft debt reduction provisions.

It is clear that there are a number of uncertainties in the Draft debt reduction provisions. Given that the proposed amendments are still in the early stages of the legislative process, these uncertainties may be addressed before promulgation. In addition to the specific uncertainties around debt capitalisation, there are a number of policy-related matters that are subsequently discussed.

5.3 General anti-avoidance rules (‘GAAR’)

Section 80I determines that the Commissioner may apply the GAAR contained in sections 80A to 80L as the alternative for, or in addition to, any other basis for raising an assessment. In addition to the tax consequences arising from the application of different sections of the Act, all arrangements entered into by taxpayers should be able to pass the tests for the impermissibility of tax avoidance laid down by the GAAR.

During 2015, the issue of whether debt capitalisation constitutes impermissible tax avoidance was extensively debated in New Zealand. The premise on which the matter was examined is that when the capitalisation of related-party debt occurs, there is no increase in the wealth within the economic group (NZIR Policy and Strategy, 2015c:2). It was advanced that when debts are capitalised, the parties have neither given nor received full payment of the debt, from a commercial or economic point of view. Therefore, the arrangement has an element of artificiality (NZIR Policy and Strategy, 2015b:25). The New Zealand Revenue Authorities ('NZRA') went so far to conclude that the capitalisation of debt into shares is *prima facie* tax avoidance where there is no effective change in the ownership of the debtor (NZIR Policy and Strategy, 2015b:7). The NZRA also found that when its analysis into intra-group debt capitalisation began in November 2013, instances of such capitalisation decreased significantly (NZIR Policy and Strategy, 2015b:8).

The definition of tax avoidance in New Zealand, although not as extensive as the GAAR in South Africa, bear certain similarities. Key words such as 'purpose', 'effect' and 'ordinary business' are relatable to the GAAR in South Africa. It is therefore not incomprehensible that the views expressed by the NZRA regarding substance over form and artificiality can also be read into the South African GAAR regime. Despite the widespread use of debt capitalisation in South Africa, no similar investigation has been performed and no guidance on the potential application of the GAAR is publicly available. However, in the two most recent BPRs that the SARS issued in respect of debt capitalisation, BPR 246 and BPR 255, the SARS concluded by indicating that the rulings do not cover any general anti-avoidance provision to the proposed transaction. Sadiki (2016:1) correctly indicates that the SARS does not express a view on whether the debt capitalisation transaction could give rise to impermissible tax avoidance. Accordingly, there is still no clear indication of the SARS's approach towards applying the GAAR to debt capitalisation. Further guidance from the SARS in this regard is required.

5.4 Base erosion

The Davis Tax Committee (2014:12) has noted the findings of the Organisation for Economic Co-operation and Development ('OECD') that there is abundant circumstantial evidence that base erosion and profit shifting ('BEPS') behaviour is widespread and that it results in the erosion of tax in countries' tax bases. The OECD also indicates that profit shifting is but one source of base erosion and that there are various other ways in which a country's tax base can be eroded, which constitutes a serious risk to tax revenues, tax sovereignty and tax fairness (Organisation for Economic Co-operation and Development, 2013:5). The SARS also points out that protecting South Africa's tax base is vital to the country's wealth and development as the globalisation of business activities accelerate (SARS, 1999:5).

Debt creates an instrument that allows for interest deductions in the hands of the creditor. Capitalisation of the debt effectively extinguishes this instrument and the accompanying deductions result in higher taxable income, which is seemingly positive for the *fiscus*. However, capitalisation also eliminates tax revenues earned from the withholding tax on the previously deductible interest. This is due to the fact that the 'fruits' of the debt (interest) and capital acquired through the capitalisation (dividends) differ in nature and legal form. After capitalisation, the holder of shares will only receive dividends in future, while interest subject to withholding tax on the (now expunged) loan is forborne.

Allowing debt capitalisation without recourse when the creditor is a non-resident creates the possibility of debt loading even if the debt is unable to be serviced or repaid, potentially amounting to tax avoidance. Debt could simply be capitalised without any adverse tax consequences to stay within safe harbours or satisfy other risk criteria established by revenue authorities (KPMG New Zealand, 2015:2). Having safe harbours for debt levels may potentially encourage excessive debt and the unwanted behaviour from taxpayers in determining the way in which their businesses are funded. This is since having safe harbours means that creditors can accumulate debt up to the point where a safe harbour value is reached and as a result avoid possible thin capitalisation provisions for tax purposes. Creditors can consequently 'load debt' up to the point of reaching the safe harbour value, despite the fact that debt funding is not optimal in these circumstances. If no safe harbours are applicable, creditors will be encouraged to determine the appropriate method of funding from the outset. The proposed enactment of the proposed section 19A that deals with the recoupment of capitalised interest, is a positive development as an anti-avoidance provision; however, it is only applicable in respect of intra-group debt.

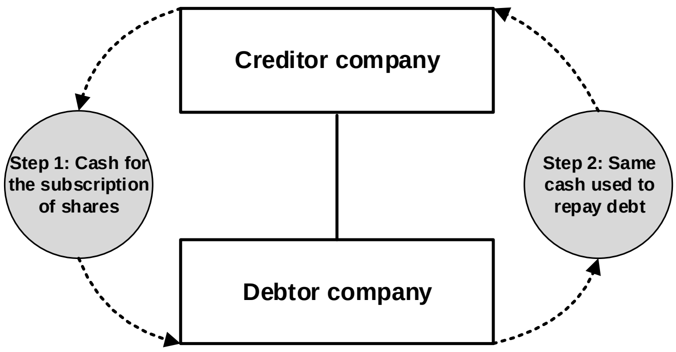
An investigation into the potential application of the GAAR to debt capitalisation and the base erosion effect of debt capitalisation in South Africa could highlight the uncertainties. This is particularly the case since as all arrangements concluded by taxpayers will stand or fall by whether they can justify that any tax benefits obtained from debt capitalisation will not be the sole or main purpose, but will merely be a complementary benefit flowing from the arrangement.

5.5 Reportability

Sections 34 to 39 of the Tax Administration Act became effective on 1 October 2012. An arrangement as defined, falling within the criteria set out in these provisions, except for those specifically excluded in the Tax Administration Act and by Public Notice, will be reportable to the SARS (section 36 of the Tax Administration Act). The Commissioner can also prescribe, by Public Notice, certain arrangements that are required to be reported (section 35(2) of the Tax Administration Act). Debt capitalisation in its various forms is not currently listed as a specific reportable arrangement.

Section 35(1)(*b*) of the Tax Administration Act, however, determines that an arrangement will be reportable if it has any of the characteristics, or substantially similar characteristics, as contemplated in section 80C(2)(*b*), which deals with a lack of commercial substance in arrangements, or the so-called tainted elements. These tainted elements include, among others, round-trip financing (section 80C(2)(*b*)(i)) and elements that have the effect of offsetting or cancelling each other (section 80C(2)(*b*)(iii)). Round-trip financing is described in section 80D as the transfer of funds between or among parties and the transfer of the funds would result, directly or indirectly, in a tax benefit, were it not for the GAAR. A further requirement is that the transfer of the funds should significantly reduce, offset or eliminate any business risks incurred by any party to the arrangement. The section is not concerned with whether the round-tripped amounts can be traced to the original funds, the timing or sequence of transfers or the manner in which round-tripped amounts are transferred or received. Especially when considering debt capitalisation through direct settlement using cash flow, many of the elements described in the definition for round-trip financing are present:

Figure 5.1: Debt capitalisation: round-tripping amounts



Author compiled

When considering the example in **Figure 5.1**, the first element of round-trip financing is present in a debt capitalisation transaction. Cash originating from the creditor company is transferred to the debtor company, who in turn transfers it back to the creditor company, both for different reasons respectively. Whether the tax benefit requirement is met, it will be dependent, as in all cases when considering the GAAR, on the facts of the specific case. This will especially become relevant in cases where the debt is interest bearing and interest flows are eliminated through converting the debt into shares. Eliminating tax-deductible interest should arguably have some sort of benefit for either the creditor or the debtor company. When considering whether business risks are significantly reduced, off-set or eliminated, Haffejee (2009:23) suggests that the concept of materiality will play a role in defining significance and correctly finds that there is an element of subjectivity when determining significance.

Kujinga (2013:115) indicates that elements that have the effect of offsetting or cancelling each other is primarily targeted at arrangements where there are complex financial derivatives present where gains on one end of the transaction is offset by losses on the other end. Although a capitalisation transaction would ordinarily not be considered as a complex derivative transaction, the very nature of set-off is that it has elements that cancel each other. Debts receivable (by creditors) and corresponding debts payable (by debtor companies) are cancelled and replaced with investments and shares issued respectively. Although Kujinga (2013:115) concludes that it is clear that there must be an intention to create losses and gains that neutralise each other, this is specifically from a GAAR perspective. Section 35(1)(*b*) of the Tax Administration Act, however, only requires that arrangements should have 'substantially similar characteristics' to those contemplated in section 80C(2)(*b*) and does not require precise comparability (section 80C(2)(*b*)). It is therefore possible that, for purposes of reportability in section 35(1)(b) of the Tax Administration Act, debt capitalisation may be considered to meet the requirements of section 80C(2)(*b*)(iii).

Although debt capitalisation is currently not specifically required to be reported in terms of the Tax Administration Act, section 35(1)(*b*) of the Tax Administration Act, read with section 80C(2)(*b*)(iii), can be interpreted in such a way that requires debt capitalisation to be reported. Based on the uncertainty highlighted, further investigation into this possibility is recommended.

5.6 Overall conclusion

In this chapter, a number of uncertainties in tax law relating to debt capitalisation was identified. In answering the secondary research question, the conclusion is reached that the other tax areas of uncertainty not addressed by the primary research questions, are relevant to debt capitalisation and can result in adverse tax consequences or administrative responsibilities imposed on the debtor and creditor.

It is noted that aspects, highlighted in the Draft debt reduction provisions, which deal directly with debt capitalisation could have a significant impact on future debt capitalisation transactions, as well as transactions already concluded. Although the Legislature has taken steps to deal with policy-related issues such as base erosion by proposing the recoupment of capitalised interest in the draft section 19B, there are still uncertainties relating to the role of the GAAR and reportability in debt capitalisation. Further clarification through Legislative amendments or guidance from the SARS as to how it interprets the relevant provisions, would undoubtedly provide debtors and creditors with a degree of certainty when entering in debt capitalisation transactions.

In the final chapter of this study, the research questions are summarised with reference to the three different methods of debt capitalisation, as well as providing concluding remarks.

CHAPTER 6
CONCLUSION

The study investigated the term ‘reduction amount’ in the Income Tax Act 58 of 1962 in the context of debt capitalisation. This is due to the recent uncertainty of whether the various methods of debt capitalisation result in a ‘reduction amount’, in terms of which the debt reduction regime applies, as contained in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act. The study addressed these uncertainties through a critical analysis of the terms ‘amount applied’ and ‘consideration’. Each of the three different methods of debt capitalisation was separately evaluated in terms of these definitions, as well as considering issues that are specifically related to the respective methods of capitalisation. BPRs on debt capitalisation that have been issued by the SARS were also analysed to determine if current practices of debt capitalisation support the analysis in terms of normal income tax legislation. In conclusion, answers to the research questions are presented in this chapter.

In answering the primary research questions posed in Chapter 1, the terms ‘amount applied’ and ‘consideration’ as part of the defined term ‘reduction amount’ were analysed for each method of debt capitalisation. It was found that for debt capitalisation to constitute an ‘amount applied’, the underlying debt that is capitalised needs to be validly discharged. In this regard, the market value of the ‘amount applied’ is submitted as important, since only the market value of shares issued during debt capitalisation would constitute an ‘amount applied’. Shares issued of which the market value is less than the debt capitalised, results in a ‘reduction amount’ as there is a mismatch in the value of the *quid pro quo* received for the release from an obligation to pay the debt. This value mismatch between the market value of the ‘amount applied’ and the debt reduced also necessitates the consideration of section 24BA. The application of section 24BA could result in adverse tax consequences in respect of shares issued at a discount or premium by the debtor during debt capitalisation. **Table 6.1** summarises the position in respect of each of the methods of capitalisation, including the impact of the market value of the ‘amount applied’ and the possible application of section 24BA.

Table 6.1 Summary of the term ‘amount applied’ for different methods of debt capitalisation

Direct settlement (Chapter 2)	Set-off (Chapter 3)	Conversion (Chapter 4)
Discharging of the debt:		
The issue of shares, although regarded as a compromise, validly discharges a debt owed by the debtor company. Cash flow is not required for the debt to be validly discharged.	Provided the requirements for set-off are met, set-off constitutes a form of payment which discharges a debt. In this regard, confirming that debts are payable by the debtor and creditor in the same capacity and not third parties is essential. Debts that have been ceded or that are not fully due as a result of suspensive conditions will not meet the requirement for set-off to occur.	The issue of shares validly discharges the debt in terms of the security document.
Market value of the ‘amount applied’:		
The market value of the shares issued will constitute an ‘amount applied’. A ‘reduction amount’ will arise if the market value of the shares issued during capitalisation is less than the face value of the debt, due to the dilution of the interest of the creditor.	The subscription loan can be recognised at the market value of shares issued, or at a premium or discount to the market value of shares. If the subscription loan is less than the face value of the debt against which it is set off, a ‘reduction amount’ will arise.	The market value of the shares issued will constitute an ‘amount applied’ and result in a ‘reduction amount’ if less than the face value of the debt, due to the dilution of the interest of the creditor.
Application of Section 24BA:		
Not applicable, as no ‘asset’ as defined in the Eighth Schedule to the Act is acquired by the debtor.	Only applies if the initial recognition of the subscription loan is at a premium or a discount to the market value of the shares issued.	Not applicable, as no ‘asset’ as defined in the Eighth Schedule to the Act is acquired by the debtor.

From the summary in **Table 6.1** it is submitted that all three methods of debt capitalisation validly discharge a debt and that cash flow is not required. Importantly, only the market value of shares issued constitutes an 'amount applied' and, as a result, a 'reduction amount' can still arise if the market value of shares issued during debt capitalisation is less than the face value of the debt.

Also evident from the summary, is the application of section 24BA to debt capitalisation in the case of set-off, which requires a two-step transaction approach (**Table 3.1**). Chapter 3 considered the application of section 24BA to the first transaction step in debt capitalisation, since the debtor acquires an 'asset' as defined in the Eighth Schedule of the Act. In this regard, a finding was made that the interaction between the value of the subscription loan and the value of the shares issued is the determining factor for the application of section 24BA, specifically:

- If the shares are issued at a discount to the value of the subscription loan, section 24BA(3)(a) applies in terms of which the debtor will realise a capital gain;
- If the market value of the shares issued is equal to the subscription loan, section 24BA is not applicable; and
- If the shares are issued at a premium to the value of the subscription loan, section 24BA(3)(b) applies, in terms of which the debtor would be deemed to distribute an asset *in specie*.

Despite the potential adverse tax consequences imposed by section 24BA, there is relief from its application if the debtor and creditor forms part of the same group of companies or the creditor holds all the shares in the debtor immediately after the shares have been issued for the subscription loan. Furthermore, it was found that section 40CA applies to all three scenarios above. In terms of section 40CA, the debtor will acquire the subscription loan at a base cost equal to the market value of the shares issued. When set-off of the subscription loan against the pre-existing debt is done as a second transaction step, the debtor will realise either a capital gain or capital loss, depending on the value of the pre-existing debt compared to the base cost of the subscription loan acquired during the first transaction step.

Having considered the impact of section 24BA and section 40CA on set-off as a method of debt capitalisation, it is submitted that selecting set-off as a method of debt capitalisation requires careful consideration. The interaction between the values of the subscription loan, the value of the shares issued, the face value of the debt and the group structure, could result in negative tax consequences beyond the scope of section 19 and paragraph 12A. These considerations will remain relevant if the Draft debt reduction provisions are enacted, since the application of section 24BA and section 40CA are not excluded in the draft provisions. Accordingly, depending on the factual circumstances, set-off could be a less favourable method of debt capitalisation than direct settlement or conversion.

The final consideration in determining whether debt capitalisation leads to a ‘reduction amount’, was if the waiver or forbearance of a right to claim payment by the creditor in exchange for the issue of shares by the debtor company, amounts to ‘consideration’. Based on a critical analysis of the term ‘consideration’, a finding was made that the issue of shares as *quid pro quo* for the release of an obligation to pay a debt does indeed constitute ‘consideration’. This conclusion is consistent with the findings of case law as well as in terms of the Companies Act and is relevant for all three methods of debt capitalisation.

Based on the summaries above, the primary research questions in Chapter 1 can be answered as follows:

(i) Issuing shares, in direct settlement, constitutes an ‘amount applied as consideration’ as contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act and does not result in a ‘reduction amount’. This finding is relevant to the extent that the shares issued as ‘consideration’ is equal to the face value of the debt.

(ii) To the extent that the subscription loan is equal to the face value of the debt, set-off does not result in a ‘reduction amount’ contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act.

(iii) The conversion of debt into shares, in fulfilment of the conversion rights attaching to the debt, does not amount to a ‘reduction amount’ contemplated in section 19 of the Act and paragraph 12A of the Eighth Schedule to the Act if the shares issued as ‘consideration’ is equal to the face value of the debt.

Despite the significant amount of analyses by academics and commentary by tax practitioners on the potential application of the debt reduction regime to debt capitalisation, there is still no comprehensive source of guidance on the tax consequences of debt capitalisation. This is clear from the number of other tax uncertainties in debt capitalisation identified in Chapter 5. Although the SARS has commented on the issue of shares in exchange for debt in its Comprehensive Guide to Capital Gains Tax and Interpretation Note 91 on Debt Reduction, these remain high-level interpretations of the relevant legislation, and do not consider debt capitalisation in great detail. A court of law may very well interpret the legislation differently to what the SARS currently appears to be doing. The BPRs issued by the SARS provide some direction on the position that the SARS may take when considering the tax consequences of a debt capitalisation transaction, but it remains applicable only to the relevant applicants. Other taxpayers may follow a similar approach to the rulings at a great risk.

Debt capitalisation is a very common commercial occurrence in South Africa and the uncertainties around its normal tax consequences and the potential application of the GAAR have been debated so extensively recently to warrant clarification through legislation. In this regard, the Draft debt reduction provisions issued by National Treasury during July 2017 is positive. However, the draft provisions in its current form have a very specific area of application for qualifying debt, and a specific debtor-creditor relationship is necessary before relief can be claimed by taxpayers. Comprehensive guidance is still required in respect of debts that do not qualify for capitalisation without recourse in terms of the Draft debt reduction provisions. Waiting for a case to be decided through a costly dispute resolution process and ultimately by the courts, may be a deterrent for taxpayers to conclude valid transactions in the fear that they might overstep the boundaries of what is allowed in terms of the debt reduction regime. On the other hand, it may create the opportunity for parties to enter into transactions of which the sole or main purpose is to obtain a tax benefit and not having their debt capitalisations being considered reduction amounts, which attract negative tax consequences.

In addition to the primary research questions that have been answered in the study, relevant considerations for other tax areas of uncertainty for debt capitalisation were also identified and documented in Chapter 5. Many of these areas of uncertainty are principally policy related, including tax avoidance and the erosion of the South African tax base. The areas investigated and documented could serve as basis for future research endeavours. Based on the findings of this research it is recommended that Legislature could consider issuing definitive guidance to taxpayers regarding the application of the debt reduction provisions to debt capitalisation which are not included within the scope of the Draft debt reduction provisions. Furthermore, the recommended guidance should also include the application of section 24BA to the respective methods of debt capitalisation.

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